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S. Hrg. 103–928

AUDITING THE AUDITORS: WASTE AND ABUSE AT IRS AND CUSTOMS?

HEARING

BEFORE THE

COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

AUGUST 4, 1993

Printed for the use of the Committee on Governmental Affairs

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AUDITING THE AUDITORS: WASTE AND ABUSE AT IRS AND CUSTOMS?

WEDNESDAY, AUGUST 4, 1993

U.S. SENATE,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Committee met, pursuant to notice, at 9:34 a.m., in room SD–342, Dirksen Senate Office Building, Hon. John Glenn, Chairman of the Committee, presiding.

Present: Senators Glenn, Pryor, Dorgan, Roth, Stevens, and McCain.

OPENING STATEMENT OF CHAIRMAN GLENN

Chairman GLENN. The hearing will be in order.

Good morning. Today, the Committee on Governmental Affairs meets to review financial management of the Internal Revenue Service and the U.S. Customs Service. These agencies are particularly important, because they represent the largest revenue collectors for the Federal Government—Customs collects many billions of dollars, and the IRS collects over a trillion dollars every year.

Congress and the public must be assured that in time of fiscal constraints, indeed, at any time, the government is effectively and efficiently collecting and accounting for its revenue. Today, we will look at how the IRS and Customs are complying with the Chief Financial Officers Act.

The CFO Act was a product of this Committee, and we have spent considerable time on its oversight. I think we are beginning to see benefits. We are beginning to see results. I know in Mr. Bowsher's report today he indicates that the CFO Act is beginning to take hold, and that is good.

In the last 3 years, this Committee has held four hearings on financial management at the Department of Defense, including a hearing on July 1st that focused on the fiscal 1992 financial audits of the Army, the Air Force and Defense Business Operating Fund.

At this hearing we talked about many, many tens of billions of dollars for which we don't have accountability. At about the same time we had a reconciliation meeting over here in which, to get something passed, we are talking about hundreds of thousands of dollars one way or another, and, yet, in the defense budget we cannot tell within tens of billions of dollars exactly where the money is going. At one Defense Department hearing we found such things as deserters and ghost employees being paid, of hundreds of millions in overpayments, inventories not controlled, and things like that—lots of waste and mismanagement. I want to start this hearing by commending IRS and Customs for their efforts to improve financial management, even though we will point out some deficiencies today.

The 1992 financial audits, which are the subject of today's hearings, are the first ever done for these agencies. In this year of 1993, that is a little hard to believe. It is the first audits ever done, and it is a challenge for agencies to expose themselves to audit.

While I recognize that certain problems will take years to resolve, I am encouraged that IRS and Customs have started to address long-standing financial management problems. IRS, for example, earlier this year established a Senior Management Council to oversee corrective actions. Nonetheless, the audits of IRS and Customs show these agencies do indeed have a long ways yet to go.

The American public will never be confident in their government if Federal agencies are unable to manage their books and account for funds in ways that most businesses already do. There can be no double standard. Americans should not put up with an IRS that makes demands on them which it cannot meet itself.

The credibility of IRS is further damaged when Americans see the agency's employees abusing taxpayer records. Recent audits revealed that IRS employees entrusted with Americans' confidential tax data have abused that trust by browsing the taxpayer records of friends and relatives, neighbors and celebrities.

Equally disturbing is that some IRS employees appear to have fraudulently manipulated some of that tax data. What concerns me is we are not talking about one or two isolated cases—one or two bad apples in the barrel. Rather, it appears that the abuse, which includes criminal manipulation of taxpayer data at IRS may be more widespread than we thought. We are talking about abuses and criminal activities across the country, and the situation obviously will not be tolerated.

A recent audit indicates that in just one IRS region, and just by using one of many computer codes, disciplinary action had to be taken against 154 employees for browsing taxpayer data for nonbusiness purposes, for reasons which had nothing to do with IRS business purposes. Five employees were prosecuted for preparing false returns or refunds, including one individual who apparently prepared 200 fraudulent returns to create false refunds. We must make certain that a thorough investigation has been done on that.

By doing back-of-the-envelope calculations, it seems that 154 of employees were sanctioned of the 6,000 employees in the region who had code access. Five were prosecuted, 369 were being investigated. That is about 1 out of every 20 employees that have access. So in that particular region, at least, IRS was looking into or had reason to be suspicious of about 5 percent of the people. That is something that obviously cannot be tolerated. I am not saying all those people are guilty, but when it comes to that extent, and we do not even know yet that we have gotten everybody ferreted out, it is obviously a very, very serious situation.

I have asked the Commissioner of IRS and the Treasury Department Inspector General to insure that this situation be fully investigated, and we look forward to their report coming back to this Committee.

The integrity of our tax system depends on an IRS that is beyond reproach and all suspicions of fraud or abuse must be completely and thoroughly investigated. I believe we are the only major industrialized country in the world that is a voluntary self-taxing people. We voluntarily give the information, and our taxes are set by the information we give. And if people lose faith in that system, then we are in very deep trouble.

Besides the computer security abuses, recent audits have brought up other disturbing findings. For one, the IRS lacks controls to ensure that it makes proper payments to its vendors. In a sample of 280 payments to commercial vendors, 32 were found to be improper, duplicate or overpayments. That is more than 10 percent of the sample. And IRS could not provide supporting documentation for an additional 112 payments. In some cases, IRS paid vendors even though the supporting documentation clearly indicated it was the vendor that owed the money to IRS.

We found similar situations at the Department of Defense during our hearing on July 1st, and now at IRS. So I begin to wonder whether any Federal agency really has control over the checks that it writes.

Audits show that Customs also has serious problems with financial management. At a time when Congress is cutting programs and public services to reduce the deficit, the General Accounting Office tells us that Customs may be losing billions in revenue because of lax internal controls over imported merchandise. In most cases, Customs just simply accepts without checking the information reported to it by importers, so that companies only pay duty on shipments about which they tell Customs. Clearly, we need better accounting for money owed the government.

Unfortunately, internal control problems also extend to the illegal weapons, drugs and currency that Customs seizes at ports of entry. It is not the first time that auditors have reported on poor controls over seized property, so I am concerned that Customs has not done more to correct this problem.

The last thing we need, when illegal weapons and drugs are such a scourge, is for Customs, through negligence or incompetence, to actually see some of this stuff return to the streets. Yet, contraband winds up missing too often. GAO reports that, in one case, Customs was unable to account for 1,850 pounds of marijuana, nearly a ton of marijuana. So we have to do better.

Let me welcome our witnesses here this morning. We are always pleased to have with us Charles Bowsher, the Comptroller General of the United States, who will be on our first panel. Following Mr. Bowsher this morning will be Margaret Richardson, the Commissioner of Internal Revenue, and Mr. George Weise, the Commissioner of Customs.

We thank you all for joining us here this morning and we certainly look forward to your testimony.

Senator Roth.

OPENING STATEMENT OF SENATOR ROTH

Senator ROTH. Thank you, Mr. Chairman.

It is a pleasure to welcome the Comptroller General and his colleagues. Today's hearing, of course, is aimed primarily at reviewing the financial audits of the Internal Revenue and the Customs Service. These financial audits are a very important addition to our efforts to improve the financial management of the Federal Government.

The requirement of agency financial statements and the auditing of these statements are key components of the Chief Financial Officers Act, which I was pleased to cosponsor and work with our Chairman in having enacted.

I look forward to this first review of two of the most important of these statements. They are, of course, the two agencies which collect the most revenue of any in the Federal Government.

However, I am particularly concerned about an issue which does not directly involve audited financial statements, that dealing with the improper access by IRS employees to citizen tax records. And one of the most disturbing findings by the IRS and contained in the GAO report relates to the weakness in the IRS computer security.

When tens of thousands of IRS employees are at liberty to access confidential information for tens of millions of taxpayers and this public trust is abused, taxpayers begin to lose confidence in the tax system. Creating fraudulent tax refunds, browsing through tax records of friends, relatives, neighbors and celebrities and violating the privacy of taxpayers raises fundamental questions about the security of our tax system.

I find it particular disturbing that the IRS is not protecting the privacy of data that American families consider most confidential. And among other sensitive information, the IRS collect data on a family's income, their home address, their medical problems and treatments, their savings, their occupations and place of employment. Taxpayers deserve, indeed have the right to have such information protected.

These revelations strike at the heart of the concerns I raised 2 weeks ago in the Senate, when we debated an amendment to the Hatch Act to keep IRS employees from active participation in political activity. I have no doubt that if these revelations had been more public at that time, my amendment to keep sensitive IRS auditors and examiners Hatch-ed would have received the one extra vote necessary for its success. These revelations make it imperative that this issue be revisited in the future.

Now, despite the laws against the activities that have been reported, it appears that many IRS employees have not hesitated to access sensitive taxpayer information for private use. And as the IRS continues to modernize its computer system, it is absolutely essential that privacy is protected and fraud is prevented.

This is particularly true, as the IRS increasingly promotes electronic filing of tax returns. Now, anyone with a home computer and a telephone hookup can access, can actually access the IRS computer networks. And while the GAO did not report on the security of the IRS electronic filing network, the GAO's findings of negligent computer security causes me to fear that many crooked people have an open path to the most private information of Americans.

In May, I asked the Office of Technology Assessment to examine such problems, and the Committee should have a report on this topic next summer. I am pleased that Senator Glenn has joined me in this request. I also want to get Mr. Bowsher's assurances that he will work with OTA to ensure the Congress learn of the full magnitude of the computer security problems that the GAO is uncovering in its audits.

Mr. Chairman, I look forward to today's hearing.

Chairman GLENN. Thank you.

Under our early bird rule, Senator Stevens.

OPENING STATEMENT OF SENATOR STEVENS

Senator STEVENS. Thank you, Mr. Chairman.

I have conflicting hearings, but I came by today to encourage you and the Committee to continue this inquiry, and I congratulate you for it.

As you know, I was one of the original sponsors of the bill to reform the Hatch Act, and I voted for the amendment that Senator Roth just mentioned to keep particularly employees of IRS under the Hatch Act restrictions. I did that, because of the increasing information that comes to our office about what the Chairman mentioned, the declining confidence of Americans in this system.

The Constitution does give the people the right to petition Congress for the redress of wrongs, but I cannot remember one instance when the IRS has backed up and said its employees were wrong. I do not know of one more audacious in the Federal Government. I often say it is the fifth branch of the Government of the United States, and it is high time that we did this, we have a hearing and go further.

I congratulate Mr. Bowsher's agency for doing a complete study. But there is more abuse there than just in the computer system, Mr. Bowsher. There is abuse in just the absolute system that refuses to admit wrong and uses information for personal purposes. And if they can use it for personal purposes, they could use it for political purposes. I still think that Senator Roth is right, and we must revisit this question.

But if there is any agency of the government that needs thorough investigation, it is the IRS. I will tell you, as I go home and speak to my people in Alaska, the anger is amazing, and just the feeling of just complete distrust stands out.

I think, Senator Glenn, you are on the right tack. I congratulate you for the CFO Act and was pleased to supposed it. But this agency clearly needs to be thoroughly cleansed out, so we can restore confidence in our taxing system. At a time when we are going to go into a period of increased taxes, there is no greater opportunity than to try and restore faith of our people in this system that is going to collect those taxes.

So I congratulate you. I hope you will continue. And, Mr. Bowsher, I hope you do not just stop at the computer system. I hope you will look at personnel policies and I hope you will look at the kind of actions that demanded a redress of wrongs to constituents and find out why some of them were not acknowledged, because I think there is a tremendous number of serious errors in this agency that need to be corrected.

Thank you.

Chairman GLENN. Thank you, Senator Stevens.

Senator Pryor.

OPENING STATEMENT OF SENATOR PRYOR

Senator PRYOR. Mr. Chairman, I, too, would like to join in applauding you for bringing this issue out into the public. This is something that, for a long time, many of us have been concerned with. Sometimes it is very, very difficult to penetrate this huge monolithic top-secret agency of government that probably is the agency in our country that Americans fear most. It is too bad it's that way, but that is the way it is.

But in the last few days, the reports that have been coming into the news media about the IRS and about the lack of privacy, about the looseness, about the ability for IRS employees, without authority, to randomly look through taxpayer files and taxpayer records. It almost seemingly says in the press, and perhaps in this hearing today, how easy it is to gain access to these records that every American must demand be treated with the highest confidentiality.

What we are seeing, Mr. Chairman, is confirming the worst fears that America has about the Internal Revenue Service. I know she is not at the witness table yet, but our friend Commissioner Richardson, brand new on the job, has a great challenge right now in turning the IRS around; especially, if these allegations and stories are, in fact, the truth.

This is not a new issue, Mr. Chairman. As you will recall in 1990, on February 20th, you received a letter from then Commissioner Goldberg, who wrote to you promising that: "The Treasury Department's Inspector General is going to provide independent and ongoing oversight of IRS inspection. To provide additional outside review of our actions to date, we have formed a Commissioner's Integrity Review Panel."

I do not know where that review panel has been for the last 3 years, nor do I know what that ongoing oversight inspection has been doing for the past 3 years. But I also know that, in January of 1990, the Commissioner of the IRS sent to this Committee a Commissioner's Interim Report on Integrity within the Internal Revenue Service. And I would say, Mr. Chairman, that this particular report probably indicates that there were some areas then, in 1990, that maybe should have sent up a red flag for us to look at.

Here is another "official use only" document, October 23, 1992,[1] that has just been revealed in the last few hours, pursuant to our very fine staff's good work in uncovering some of this and bringing this out in the public.

One thing that strikes me, on page 9 of this report of October of last year, "The IDRS security system has not been reviewed by local, regional or national management within the past 2 years in two of the three regions. During this time, other initiatives, such as preventing mini and micro computer viruses, took precedence over IDRS inspection group that looks at this."

In April of 1992, a GAO report done at this Committee's request by Mr. Bowsher's group indicated that there are eight factors that IRS needed to address to help insure the success of the system modernization effort. Eight items! First, going down to No. 8, I should say, you have completion of a key planning component, im-

[1] "Review of Control Over IDRS Security" appears in the Appendix on page 334.

plementation of a project tracking mechanism, and the last item in priority, No. 8, "paying greater attention to security and privacy issues."

I would respectfully suggest that No. 8, paying greater attention to security and privacy issues be moved up to No. 1, because if we break down the credibility of the Internal Revenue Service, the tax collector, people are going to have no faith and they are not going to pay taxes, and we must have a fair and effective system of tax collection.

This situation makes me even more committed to push for the Taxpayers Bill of Rights, No. 2. I tried to get it in the reconciliation bill, and I must say I was not successful. Both Senator Glenn, the Chairman, and Senator Roth have been cosponsors of that legislation, and I am going to continue pushing for the Taxpayers Bill of Rights No. 2. We enacted TBR No. 1 in 1988. It has now been implemented and I hope TBR No. 2 will ultimately be enacted.

Mr. Chairman, I salute you and I salute the staff of this Committee for their good work.

Chairman GLENN. Thank you very much, Senator Pryor.

Our first witness this morning is the Hon. Charles Bowsher, Comptroller General, General Accounting Office, accompanied by Donald Chapin, Assistant Comptroller General for the Accounting and Information Management Division, and Greg Holloway, Associate Director for Civil Audits of the Accounting and Information Management Division.

Mr. Bowsher, as always, we look forward to your testimony here. Welcome to the Committee again, and we look forward to your statement.

TESTIMONY OF CHARLES A. BOWSHER,[1] COMPTROLLER GENERAL, UNITED STATES GENERAL ACCOUNTING OFFICE; ACCOMPANIED BY DONALD CHAPIN, ASSISTANT COMPTROLLER GENERAL FOR ACCOUNTING, INFORMATION MANAGEMENT DIVISION; AND GREGORY HOLLOWAY, ASSOCIATE DIRECTOR FOR CIVIL AUDITS, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION

Mr. BOWSHER. Thank you very much, Mr. Chairman, Senator Roth, and Senator Pryor.

We are here today to discuss the results of our recently completed financial statement audits at the Internal Revenue Service and the Customs Service, and the need to accelerate government-wide financial management reform through the full and effective implementation of the Chief Financial Officers Act of 1990, which I again salute this Committee for leading the way to pass that legislation.

Our financial audits at IRS and Customs now show that serious financial management problems exist at the Department of the Treasury. The results of these audits and our work at the Department of Defense, on which I testified before you on July 1, 1993, demonstrate the necessity of preparing and auditing annual financial statements.

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[1] The prepared statement of Mr. Bowsher appears on page 81.

If you remember, Mr. Chairman, one of the things I pointed out at that time is that the Treasury has been accepting year-end statements from the Defense Department and other agencies that are just wrong, even with plugged numbers.

I think one of the problems we see here is that they have even been accepting misinformation from their own agencies over the years, and that is why, I think, that Treasury has got to get on top of this financial management area, and I intend to speak personally with Secretary Bentsen on this. I have talked to Deputy Secretary Altman. But I think the Treasury has to play a very key role in getting this whole financial management area straightened out, because they are the ones that really do at the end of the fiscal year accept the statements from the various agencies.

Now, the CFO Act's pilot program of agency-level audited financial statements has proven that this process pinpoints problems and provides the road map needed to provide financial accountability and control. The audits are demonstrating that there are specific flaws in budget execution needing correction, that particular steps should be taken to improve efficiency and effectiveness of the government, and that better accountability measures will protect against unnecessary losses.

It is my hope that the requirement for audited financial statements will be expanded to all major agencies and departments in the government, and implementation of the CFO Act will be strengthened. We also believe that the time has come to arrange for audited government-wide financial reports that will tell the American public where its government stands financially.

Now, through the CFO Act's pilot financial statement audits, IRS and Customs management have begun the process of improving their financial reporting and the quality of the underlying financial and program performance data. Also, they have gained a greater insight into the areas needing improvement and are now better able to focus on solutions to fundamental problems for which a number of corrective actions are already under way. Further, the Congress has a better idea of how these organizations are actually functioning. Among the results of these financial audits are the following:

First, the Congress now has reliable estimates of IRS' receivables and the related collectible amount, which are tens of billions of dollars less than what had been reported by the agency in the past. Also, management efforts of the IRS to address the collection function can now be better focused.

In other words, the statements previously had reported receivables at over $100 billion, about $105 billion, of which our audit and the work that the IRS itself has done indicates that about $65 billion was valid, but only about $19 billion was really considered to be collectible. This is very important information, to get your balances correct and then figure out what you can go out and really try to collect.

Second, revenue information at IRS and Customs, covering over 99 percent of the government's total revenues, in other words, over a trillion dollars, has undergone an audit for the first time, highlighting for management's attention a wide range of problems with the quality of the information and with fundamental internal controls over billions of dollars.

For instance, IRS is now working to overcome a problem whereby its systems could not provide details as to amounts of specific excise taxes collected. As a result, general tax revenues inappropriately subsidized excise tax trust funds, perhaps by billions of dollars. This condition has important management implications and may have some effect on our excise tax policy. Also, IRS cannot determine the amount of the general revenue fund subsidy to the Social Security Trust Fund.

The third point, Mr. Chairman, is one that you have already made quite well, and that is that IRS is presently focusing on fixes to problems involving unauthorized access to taxpayer information and serious weaknesses regarding the use of its appropriated operating funds that have led to unreconciled differences between its records and the Treasury cash records, unresolved discrepancies and transactions in suspense accounts, and duplicate and other inappropriate payments to contractors.

One of the things we found was lack of documentation sometimes for these payments to contractors, and if you think about it, if the taxpayers could not produce support for their disbursements, those disbursements would be disallowed by the IRS. So this is an important function that should be done as well by the IRS as they require of any ordinary taxpayer.

Now, at Customs we noted many opportunities for seized drugs, weapons and currency to be stolen or misappropriated without detection. The audit has provided additional impetus to address some serious control weaknesses evident throughout the seized property process, from the time property is seized until disposed of, that could result in financial loss to the government or danger to the general public.

I would just like to go into that in a little more detail. Customs reported $542 million in seizures during fiscal year 1992 and an ending balance of $489 million in seized property in its financial statements. The policies and procedures the agency established to control seized property though were not consistently and effectively implemented. We identified weaknesses in internal controls throughout Customs seizure process from the time property was seized until the time of its disposal. Seized property was vulnerable to theft or loss, which could result in financial loss to the government or, as I said previously, danger of the public, and I think here are some examples:

The transfer of seized property from seizing officers to seizure custodians for safeguarding was often delayed. Over 50 percent of the 118 items we tested were not transferred within Customs' prescribed 2-day maximum. In fact, the average was 35 days. In one instance, about half a pound of heroin was held by the seizing officer from August 11, 1992 until March 16, 1993, when we visited the Customs district involved, and no one was able to give us an explanation for the reason for that delay.

Also, seized drugs were not properly weighed and tested, creating an environment where drugs could be stolen without detection. For instance, although Customs has established procedures to weigh drug seizures, we found a case where the shortage of 1,850 pounds of seized marijuana could not be accounted for. Customs was unable to explain the discrepancy, other than to state that the initial weight assigned to the marijuana was probably an estimate and that the seizure had not been weighed as required at the time of receipt.

Also, storage facilities were not properly protected. At 14 of the 20 Customs seized property storage facilities we visited, we observed that unaccompanied seizure custodians had access to vaults. None of the 20 Customs districts we visited had security cameras in their vaults, and 2 sites containing very large bulk quantities of drugs had open physical access in full public view.

Further, Customs did not adequately control millions of dollars in funds advanced to its agents for special operations, such as undercover work and payments to informants, or the sensitive documents relating to these advances. For advances, Customs' accounting records had to be adjusted from $37 million to $19 million, to show the correct balance at year-end. More serious, though, sensitive documents supporting special operations transactions were not adequately safeguarded.

At Customs' National Finance Center, sensitive documents were routinely stored in an open filing cabinet in an unlocked room or were left unattended on a desk. Failure to adequately protect these documents could threaten the safety of informants and Customs agents, compromise important relationships with informants, and undermine Customs' credibility.

In my July 1st testimony, I spoke to you about the need for leadership at the Secretary of Defense level to address long-standing financial management weaknesses. The problems we have identified at IRS and Customs, coupled with our findings at Defense, demonstrate not only the need for agency leadership, but I also believe for strong leadership at the Presidential, the Office of Management and Budget and the Treasury level, and I certainly hope that Vice President Gore, when he releases his NPR report here in the next month will speak to these concerns and that they plan to initiate a program for strengthening financial management in the Federal Government.

Our financial audits at IRS and Customs represent the first such audits of these organizations, requiring a very major effort by these agencies, and I would like to recognize both agencies for their cooperation and strong efforts to implement the CFO Act. In contrast to the concerns I raised to the Committee on July 1st regarding the Department of Defense's response to its serious financial management weaknesses, both IRS and Customs management have been very responsive to our audit findings and have made progress to developing reliable information and establishing financial control.

I might also point out that I think at the IRS we have had a series of Commissioners who have wanted to make improvements, and I think, as Commissioner Richardson will point out in her testimony here, that a lot of this improved effort started with our management review back in 1989, and we have had three Commissioners right in a row here who have tried to move on these issues, and I am very pleased with the progress that they are trying to make over there.

However, we have to report here that, on the opinion of the reliability of the 1992 financial statements, critical supporting information for billions of dollars was either not available or was unreliable and, therefore, we could not give a clean opinion.

Preparation of the financial statements presented a substantial challenges to the IRS and Customs, and this undertaking was made especially difficult, because their existing systems were not designed to provide meaningful and reliable financial information needed to effectively manage and report on their operations.

Compounding this problem, internal controls were not designed and implemented to effectively safeguard assets, provide a reasonable basis for determining material compliance with certain laws and regulations and assure that there were no material misstatements in the financial statements.

IRS and Customs have begun the process of rebuilding their financial management processes and system. Continuing strong implementation of the CFO Act by these agencies can result in a tremendous payoff to an improved ability to safeguard assets, to manage operations and to collect revenues. The job will not be easy and it will take a number of years.

I think we now can report that the Social Security Administration has been working on this issue for a number of years and, except for unresolved differences in wage certification and the accuracy of accounts receivable, they can get a clean opinion on their statements and they can release their statements early in the next fiscal year. So we have seen a good example of how this can be done, and I am confident that the IRS and I am hoping Customs can move forward and be just as big a success story here in a few years.

Using audited financial statements is an important foundation to improve financial management, IRS and Customs will have to overcome a broad range of very serious problems that our financial audits have identified, and this will require high-priority management attention at these two agencies and congressional support.

Mr. Chairman, that concludes my summary. We would be happy to answer any questions that you may have.

Chairman GLENN. Thank you very much, Mr. Bowsher.

I have gone through your complete statement, and the whole statement will be included in the record. There is a lot more information in it, also, and it is very valuable information.

What was basically the difficulty in leading GAO to be unable to render an opinion on the statement? Can you be more specific on that?

Mr. BOWSHER. Well, the audit has to rely upon the data that is in the systems and the records. There we found some real problems with the basic records and some of the systems, and we just did not find the reliability that you have to have as auditors to certify to those statements.

Greg Holloway was in charge of the audit, and I might ask him to amplify what were some of the problems.

Mr. HOLLOWAY. A couple of problems, using IRS, one would be the things you have to do to evaluate whether or not the amount that they report as revenue, in terms of how they allocate the revenues that they collect, is accurate.

At the time of our audit, IRS was unable to provide for us the detailed support for the numbers that they had. Therefore, we had nothing to audit. So that would be an example where there just was not detailed activity that showed what made up the balances.

Another example would be both agencies where they attempted to have the records on their fixed assets. In addition at Customs, in the area of seized assets, where they had records, but when we went in to test those records, we found that they were materially incorrect, which made them basically unreliable. And while they made efforts to try to improve those and correct those balances, based on the audit work that we did and because of some of the limitations as a result of that work, we just were not able to form an opinion as to whether or not everything was included. And there is a series of other examples that we could give you on those.

Chairman GLENN. You reported also, I think, that GAO reported that IRS financial reports were misstated, in that they had not analyzed over $150 billion in account balances. Is that right?

Mr. HOLLOWAY. That is correct.

Chairman GLENN. They do not know within $150 billion. I am not saying there are problems with these funds, but they just were not audited. We may be at least $150 billion off, or at least there is that potential?

Mr. HOLLOWAY. What it actually means is that you had a situation where it wasn't so much that they were not able ultimately to determine where the money went, it is that they did not do it in a timely manner. So what you had is the receivables that were reported were, in fact, probably overstated, because receipts received to be applied against those receivables had not been applied against the respective taxpayer accounts. So it gave the appearance that more was owed than what actually was owed.

Chairman GLENN. Mr. Bowsher, on this unauthorized access to tax data, I think, that everybody relates to it. Is somebody I do not know going through my tax account, my tax statements and misusing them? Are people getting unauthorized refunds because the files were improperly adjusted, maybe even with that person getting a kickback or something like that? I do not think we know the full story on some of these problems yet.

What are the details on this?

Mr. BOWSHER. You know, when we do a financial audit, one of the things we did is we always look at the internal audit reports that the Inspector General or the internal audit group has done. And we did that, of course, in this case, too, and we found that the internal audit had actually turned up this problem in the report.

What you have here is you installed a system about 20 years ago called the IDRS system, and it has been their primary computer system for assessing and adjusting taxpayer accounts, and what the internal auditor did was he went and checked on one command code in one district in the Southeast, and that is where he found that the employees were actually accessing that when they should not have been.

OPENING STATEMENT OF SENATOR McCAIN

Senator MCCAIN. How did he know that?

Mr. BOWSHER. What is that?

Senator McCAIN. How did he know they were accessing the data?

Mr. BOWSHER. Because he obviously went through and looked at the records which were probably sitting in the computer system.

Mr. HOLLOWAY. Actually, what happens is in any computer system you have a security system that is part of that computer, and because the way you enter the system is you have to have a password code, it identifies who went into the system and for what purpose.

So what they basically did was took all of the accesses that had been made over a 3-year period and ran several trend analyses and some other things to try to identify things that appeared to be abuses, like going into relatives' accounts or going into people that had stature accounts or whatever, that looked unusual. And from that they then did subsequent investigations to follow up on the ones where there seemed to be excessive accesses to those accounts.

Mr. BOWSHER. If I could just read a couple of paragraphs from the internal audit report, I think it would also give you a good idea.

Chairman GLENN. Before you do that, I might add that this was just one account out of 56 different potential accounts, right?

Senator McCAIN. Command codes.

Chairman GLENN. I mean command codes, access to codes.

Mr. BOWSHER. And at one location, too.

It says here: "Our computer analysis was limited to one command code which is assigned to approximately 6,300 Southeast Region IDRS system users. The command code is used to assist Internal Revenue Service employees in determining if a tax return has been processed and the amount and date of the refund. The command code is considered a research command code, because employees cannot use it to change taxpayer accounts. The code was used about 2 million times during 1989 and 1990 in the Southeast Region"—so you can see that this is something that is used very frequently.

"Our analysis of the code usage found strong indicators that 368 employees monitored non-work-related accounts." And that is what the auditor went after, was non-work accounts, including those of friends, relatives, associates, neighbors and celebrities.

"Of the 368 employees, 289 were referred to their respective heads of office for administrative follow-up and appropriate discipline action. The other 79 employees were referred to internal security for evaluation and investigation of potential criminal violations by the employees. To date, the investigations have established that 4 employees prepared fraudulent returns for taxpayers and then monitored the accounts on the system. The action of these 4 employees are being reviewed by the appropriate U.S. Attorney for possible prosecution."

Senator McCAIN. Mr. Chairman, if I might follow up with your indulgence, if this is 1 out of 56 codes in just one part of the country, how do you extrapolate that as to the extent of the abuses that might be taking place?

Mr. BOWSHER. I do not think anyone really knows the answer to that question, Senator, and I do believe that is one path that the IRS ought to follow very carefully now. I think they have looked at two other areas, I believe they have reported, and they are trying to shore up the security on the system. But I think one of the things they might want to consider is looking at more locations, just to see if they have not got more of a problem in this area, because as the Chairman and yourself is raising here, this is a very serious issue. I know I talked with the Commissioner yesterday. I know she thinks it is a very serious issue, and I think they have to get on top of it.

Chairman GLENN. She will be testifying in a little while. I indicated in my opening statement that what happened in the Southeast, where you have a little over 6,000 people with access to these systems. You have a cloud, at least, over some 369 people and that comes down to 1 out of 20. You are talking about 5 percent of the people doing things in there that were improper—as far as doing their job went. So I would be very surprised if there was not the same kind of thing happening, elsewhere. I cannot believe it would just happen in one part of the country with one little group of people and not be more general in nature.

My time is up. Senator Roth.

Senator MCCAIN. Did you want to add something?

Mr. HOLLOWAY. Well, I was just going to add that, as the Comptroller said, I suspect and I would have to revisit their methodology, the way that they picked one unit, you can only speak to the area they looked at. And I think if there would be a question raised, it would be, as he indicated, that it would suggest that possibly they should have gone to more places to see if that same problem persisted, because of the serious nature of the problem.

Chairman GLENN. The only comment, before Senator Roth begins is to say that IRS' own internal auditors looked at this—that is how they turned up some of this problem, correct?

Mr. BOWSHER. That is correct.

Chairman GLENN. So I do not want to indicate that IRS was trying to cover this up.

Mr. BOWSHER. No.

Chairman GLENN. They were investigating some of this. So IRS should get some credit for looking at this, also, although it should never have happened in the first place, obviously. I wanted to make that clear.

Mr. BOWSHER. I think it shows the importance of audits, internal audits, external audits. In other words, you need a periodic review of how good are your controls, how good are your systems.

Chairman GLENN. Senator Roth.

Senator ROTH. Mr. Bowsher, I guess the key question is what can be done now to correct this. This is not a matter that we can spend years or months trying to correct. You have the credibility of the Internal Revenue Service at stake. The thing that bothers me is I understand an outsider—it is not only those that have access inside—but an outsider with a little knowledge and technique can gain access. Is that correct?

Chairman GLENN. A hacker?

Senator ROTH. A hacker?

Mr. HOLLOWAY. I do not believe that is true. At least nothing came to our attention that suggested that somebody from the outside could have accessed that information. All of these people were people who had been authorized based on their jobs to have access. So what was in question is were they going beyond the requirements of their job in looking at some of the things that they elected to look at.

Chairman GLENN. If you would just yield one second, we will give you extra time.

Senator ROTH. Yes.

Chairman GLENN. That is a very good question. As you know, we had hackers getting into some of the Defense Department systems and intelligence systems, and we have tried to put in special protective coding and things there. Are we going to need something like that here? Can a hacker get into the IRS system?

Senator ROTH. I am told, and one of the reasons I requested the study to be made by the Office of Technology, is the fact that our computers are accessible to experts in foreign countries, people at home. What can we do to begin to address this problem? I find it very serious. You not only have the Internal Revenue, which most sensitive as far as the public is concerned, but our secrets, our confidential information is accessed. What can we do about this?

Mr. BOWSHER. Well, I think you have to build in system safeguards here, and I think that one of the questions you should be asking the Commissioner is what is their plan to do that now to the current system.

Senator ROTH. I guess what we are asking is, both the Chairman and myself, is there a safeguard system available now, and if not, what can we do to develop one?

Mr. BOWSHER. Well, there are safeguards that you can design in the system. What you have really here at the IRS is you have the current system that should have added safeguards put into it. They are working, of course, on a new system, and certainly as they design that new system, one of the things we will be looking at and monitoring is are those safeguards there.

One other illustration, too, that you have to be very careful about in this kind of situation, and that happened at one other very sensitive Federal agency, and that was a former employee had some of the codes and came back and got into system. So the security area is very, very important, and I think that is a reason again why the systems reviews that should be done on a periodic basis, and then to be audited by somebody from the outside is very, very important.

Senator ROTH. Let me ask you this, because part of the problem is not new, it is a question of the responsibility and accountability of the individual employee. You had that same problem even before you had computers, because they were typed on paper and filed, so those files were accessible. Is it a question that our personnel policies are not adequate?

Mr. BOWSHER. I think that is a very important area of training and ethical training. It should be very much a part of the program, and I think in the report there they indicated there had not been as adequate a program in that area as there should have been.

So I think you are absolutely right, you have the systems that you should be building in the safeguards in your system design, but you should be training your people as to what is right and what is wrong on this kind of thing, because historically you have always had the access problem. In other words, there are records and people have access to it and you have to make sure that people are not violating their privilege of looking at those records.

Senator ROTH. To change to another area for a moment, how long is it going to take us to get the financial records that we can rely upon? You and I and the Chairman, we have been talking about this for so many years.

Chairman GLENN. The last decade.

Senator ROTH. The last decade. You know, we keep saying we are making a good beginning—beginning, hell, when is it going to be accomplished? I think that is what has got the public so unhappy.

Mr. BOWSHER. Well, I think it takes about 3 years for any of these large agencies to get the job done so that we can generally audit it and give a clean opinion, unless there is an extraordinary problem there. It is hard to do it in less than 3 years.

As I say, the Social Security Administration, which is as very large agency, is making progress. The Postal Service, when they became a quasi-corporation some years ago, they were able to do it in about 18 months to 2 years. I remember we got New York City in a position to be audited within 2 years. On the RTC, it has taken what, 2 years or 3 years?

Mr. CHAPIN. Three, I think.

Mr. BOWSHER. Three years on the RTC, which was as new agency, but one that had immense problems, taking over $300 to $400 billion of seized property or property that had to be taken over. So this is not a 1-year effort or a 2-year effort, but it should not be something that cannot be done in 3 or 4 years.

Now, the big problem I think, one of the things the Congress ought to think about, and that is when you passed the CFO Act, you got certain agencies started down the right path, like getting an annual audit and finding out what their problems are. You do not have that in all of the 23 largest agencies.

So I think one of the things that you ought to consider is whether you should not be extending the CFO Act to include the 23 largest agencies, and that includes 95 percent of the assets and 95 percent of the operating revenues of the Federal Government, and then at some point after that I think you would have them all in place. But it does take a few years for each agency.

We run into these problems that we are reporting on IRS and Customs at every major agency that is getting their first-time audit. In other words, the records are in poor shape, the systems are not adequate, and the discipline of putting out the annual financial report is not there. That is what we reported, if you remember, in the Army, the Air Force and some of the other civilian agencies, but we are making progress here. In other words, the CFO Act was the trigger to start making progress here. I wish it was faster, Senator, I really do.

Senator ROTH. You mentioned Social Security. I have not had a chance to carefully study all of your testimony, but you talk about a subsidy from general revenues.

Mr. BOWSHER. Yes.

Senator ROTH. I thought we had a surplus in the trust fund. [Laughter.]

Mr. BOWSHER. You do have a surplus, and one of the reasons you have a surplus is they get their bookkeeping entries. Let me have Don Chapin explain that to you.

Mr. CHAPIN. Generally speaking, Senator, the funds for Social Security payments come in separately from the returns and, by law, the returns have to establish the employee accounts. So each employee should have his account credited for the amount that was actually based on his wages. When we do not get all the taxes however, the money does not come in, so the Congress has decided that, to the extent there is a shortfall in the money, that the money still has to be provided, so it has to be taken out of the general fund, in effect, to make up the shortfall in collections.

Senator ROTH. Why does the money not come in?

Mr. CHAPIN. Employers, for example, do not remit the money that is due. They fail to pay.

Chairman GLENN. I went through this in preparation for the hearing. The accounts are such that you know what should come in by the rates and the approximate number of people paying, but your records are such that you do not know whether it actually came in.

Mr. CHAPIN. Right.

Chairman GLENN. Your pay-outs out of Treasury are done on a certain basis, and so if there is a shortfall between those two things, we just pay out of general revenue, because the records are such that we are not sure what came in.

Mr. CHAPIN. Yes.

Mr. BOWSHER. It is basically an accounting.

Senator ROTH. What can we do to correct it?

Mr. CHAPIN. Money comes in every quarter on the quarterly returns from employers.

Senator ROTH. It is a failure of collection?

Mr. CHAPIN. It is an enforcement problem, Senator.

Senator ROTH. How can we correct it?

Mr. CHAPIN. You have to make enough examinations of these employers. Also, sometimes you fail to get money when companies go bankrupt. The employees have earned their credits for Social Security, but the employers fail and go out of business, there is not enough money to make up the tax payments due.

Senator ROTH. My time is up, but it never fails to amaze me. If private industries kept its accounts like we do in government, they would be in jail, and here we are still talking. God bless you, your office has been fighting for it, the Chairman and I have, but it is just unbelievable that, in 1993, we have records that are totally inadequate and it is going to take several years.

Mr. BOWSHER. Senator, I think the public just does not understand why their Federal Government cannot keep their records.

Senator ROTH. I think they are right.

Mr. BOWSHER. Yes, they are absolutely right. We got the State and local governments finally straightened out after the New York City fiscal crisis, and this Committee again passed the legislation that finally propelled that. I just think we have to keep working here at the Federal level and get it done, because the public just does not understand.

Chairman GLENN. Senator Pryor, I think you were next, and then Senator McCain and Senator Dorgan.

Senator PRYOR. I just have one question. Is there any way those individuals whose confidentiality may have been violated, that they can be notified of the violation, or should they be notified? I am going to ask that of the Commissioner, also.

Mr. BOWSHER. I think the Commissioner would probably be able to answer that question better than we would.

Senator PRYOR. Does our system have a mechanism to do this?

Mr. BOWSHER. I think the internal auditors' records would indicate what records were looked at, so they have the information. Just how to deal with the individuals, I think you had better ask that question of the Commissioner.

Senator PRYOR. I will ask that of the Commissioner.

Mr. Chairman, I yield back my time.

Chairman GLENN. Thank you.

Senator McCain.

Senator MCCAIN. Thank you, Mr. Chairman.

Finally, on this issue of the trust funds, what is the actual impact on the Social Security Trust Fund of this?

Mr. BOWSHER. The real impact is that the excise taxes and the Social Security Trust Fund gets the larger number credited to them, and the general revenue fund then really gets what is left over in the revenue. In other words, the records are not good enough to give a really accurate accounting of how much really came in for excise taxes and how much really came in for Social Security, but they lean towards trying to give the benefit of the doubt to the trust funds and to the excise taxes, and if there is any shortfall, it is in the general revenue.

Now, when you are talking about the trust fund, you are basically talking about an accounting entry there, because all the money goes into the Treasury that is received.

Mr. CHAPIN. What we see is an enforcement problem that is not clear, because we do not know exactly what these shortfalls are. If we knew what the shortfalls were, for example, we might be better able to enforce the excise tax laws. We might even change the laws, based on better information as to tax collectibility. But as long as you do not have the information, you have to assume, because of the way the things are accounted for, that all the Social Security money is coming in and all the excise tax money is coming in, which is not true. So it is an information problem for policymakers and for enforcement people.

Senator MCCAIN. What does this say to senior citizens as to the security of the trust fund?

Mr. CHAPIN. I do not think that the senior citizens need to be concerned, because there is this subsidy that makes up the trust fund payments. It is not a concern of them. It is really a concern of policymakers and enforcement people, because if you do not know what you are not getting, you are not going to have a chance of fixing the problem.

Mr. HOLLOWAY. Can I expand on Don's point just for one moment?

Senator MCCAIN. Before you do that, if you do not know what you are not getting, then how do you know that the trust fund is secure?

Mr. CHAPIN. The trust fund payments are based upon the wages earned by the employees.

Senator MCCAIN. Yes.

Mr. CHAPIN. All reported wages earned are the basis for the payments to the Social Security system, so all the money is going over there, in effect. So you should not be worried about the Social Security funding. You should be worried about the subsidies that have to come out of general funds that have to make up these shortfalls.

Senator MCCAIN. I see. Did you want to add something?

Mr. HOLLOWAY. That is certainly one of the concerns, but I think one of the things that GAO has reported on in the past that I think is a very significant concern is what really occurs is that wages get reported to the Social Security Administration, generally speaking, based on what is called the W–3/W–2 wage earning statement.

One of the dilemmas that this whole problem creates and why it is so important to have accurate information is the basis for funding Social Security is actually the 941, which is the quarterly tax returns that corporations file with IRS, is the basis for the payment.

But, historically, what has happened is the basis for the payment has been higher than the actual wages reported to Social Security, and the significance of that is that we the taxpayers likely have our Social Security record incomplete, because what would occur, for example, if you worked for a company that went bankrupt and they did not file the annual statement with Social Security, it is highly probable, since that is the primary source for their records, that your Social Security contribution did not get credited.

So while Don is correct that the monies for the trust fund are there, the individual accounts of taxpayers very well could be understated.

Senator MCCAIN. Mr. Bowsher, obviously, alarm bells went off all over the Senate and I am sure with the American people, when they read the story about people having their privacy violated, which is basically what has happened here, and it confirms the suspicions of many Americans that government now intrudes to much and inappropriately in their daily lives.

Although it may be a minor part of the overall problem, I think there are many Americans who will want to know what needs to be done to correct it. I would appreciate recommendations from your office, and I am sure we will get from the witness further concrete recommendations that I can respond to my constituents with as to what needs to be done to stop this frankly outrageous practice. Also, I think it is probably not your duty, but probably the responsibility of the Commissioner, to find out how widespread this abuse has become.

So I would appreciate it if you could provide the Committee with a specific list of proposals as to how GAO believes this problem can be cured. You have mentioned some already.

Mr. BOWSHER. We would be pleased to do that. I talked this morning with my top IRS systems person, Hazel Edwards, about this problem and we are definitely going to monitor the design of the new system very carefully in this area.

Senator McCain. Thank you. That brings me to my next question. In your view, should we commit the taxpayers of America to the IRS's $9 billion modernization project, without first having the proper safeguards in place and installed in that system that would prevent these abuses?

Mr. Bowsher. Well, what you have here is you have the current system that is being used, and that is where the problem is, and you have to get on top of that. Then you are designing a new system and I think you badly need the new system.

In other words, one of the problems at IRS overall which we identified in our management review, and which has been the subject of quite a few congressional hearings, is that they are really limping along with very old antiquated systems at the IRS, and so the investment in the new systems is really badly needed, but it has got to be done right. In other words, when you are investing in this kind of a large new system, it is very important that it be done right, and we are going to try to monitor very carefully for the Congress.

Senator McCain. Thank you, Mr. Chairman.

Chairman Glenn. Senator Dorgan.

OPENING STATEMENT OF SENATOR DORGAN

Senator Dorgan. Mr. Chairman, thank you very much.

The disclosure of unauthorized access to or use of taxpayer financial records is of major consequence, in my judgment. The whole foundation of our tax system rests on the notion that the most sensitive information about people's lives, their financial information, is subject to confidentiality requirements and criminal penalties will apply to those who breach that confidentiality.

My heart sank a bit when I saw the press reports and the studies that show that one code in one area has some 300 examples of unauthorized use of or browsing through taxpayer records. I would like to ask you just a couple of questions about that.

First, I think it is imperative that from this information there now be a systemwide evaluation to find out is this a chronic or an isolated problem. If it is a chronic problem, how widespread is it? What is the dimension of the problem? Is there now underway a broader-scale evaluation of access to these records?

Mr. Bowsher. I think they have looked at some other areas of the IRS, some other service centers, but I do not think they have done a look at all of the service centers. I believe, Greg, it is two that they have looked at?

Mr. Holloway. They have done very limited tests in a couple of other regions, but I think that one of the things that they are embarking on doing is to try to take what they learned from the Southeast and integrate that into a monitoring system.

Senator Dorgan. You say they have done a very limited look at other areas. When the IRS finds these results in Atlanta, shouldn't they say: Wait a second, what's going on here? We had better see what is going on all across this system in every region of the country. Is that not being done?

Mr. BOWSHER. It is not being done to the best of our knowledge, but I would ask that you also ask the Commissioner to make sure that we have the right information on that.

Senator DORGAN. Do you think it should be done?

Mr. BOWSHER. Don Chapin here this morning just raised that before we came over here and said that he certainly thinks it should be done.

Mr. CHAPIN. I would call out the Army for that one.

Senator DORGAN. Pardon me?

Mr. CHAPIN. I would call out the Army for that one.

Senator DORGAN. I would think so. I understand that you will have a breach from time to time, because there are people who will behave criminally. When that happens, you find them, you prosecute them, and you move forward. But this deals with a system failure of significant proportions in one region. It seems to me that, first, you need to find out what the dimension of this problem is, and, second, you need to put an end to it quickly.

Mr. BOWSHER. Yes.

Senator DORGAN. There is a motel near the airport in Minneapolis. Near the front door of the motel is a parking space that everyone would like to park in, but the manager who owns this parking space put up a sign that says, "Don't even think about parking in this space." You look at that sign and, I will tell you what, you do not even think about parking in that space.

That is the way we have to begin with people who work for the Internal Revenue Service. We need to say: Don't even think about browsing through files, don't even think about unauthorized disclosure of taxpayer information. I am just wondering, have you evaluated the training system for people? Are they signing disclosure forms? Are they signing pieces of information that demonstrate they have read all the requirements on confidentiality, they have gone through a training period, and so on? Are you satisfied with that process, so that they understand that they shouldn't even think about this?

Ms. EDWARDS. I think it is a fact, Senator Dorgan, that IRS takes seriously this issue and that they do have training programs in place and orientation programs for their employees. This is an instance, however, where we see there is a need for further improvement. It is not that IRS has nothing in place in terms of training and teaching and reinforcing this point.

GAO has over the last year or so had a number of reports on the issue of taxpayer abuse, and we have gone to the question of whether or not the employees really are oriented to think more proactively in terms of fairness to the taxpayer. It is a fact that IRS is pushing this issue, but here is an area where we need to push more firmly.

Senator DORGAN. I am reading now from a report on some of the findings: "Of the 369 cases, 345 were referred to management for review and 154 were disciplined. Of the 154 who were disciplined, three were forced to resign, three were fired, and the rest were either reprimanded, suspended or underwent counseling."

What on earth kind of counseling would be advisable for an employee who violates confidentiality of taxpayer returns? When you find people doing unauthorized things with taxpayer records, do you not fire them? Mr. Bowsher, can you explain what the IRS is doing here?

Mr. BOWSHER. I think that is a good question for the Commissioner. [Laughter.]

In other words, I really do not know about that particular case.

Senator DORGAN. Does it strike you as unusual that, in cases where there is unauthorized access to or use of taxpayer information, the remedy is to counsel them?

Mr. BOWSHER. We just have not investigated those individual cases, so I think I would just have to let the IRS speak to that.

Senator DORGAN. I will ask the Commissioner. But in the event I am not able to get all that information, could you at least attempt to find out for me what the nature of this counseling is and send it to us?

Mr. BOWSHER. We could. We certainly could do that.

Senator DORGAN. Senator Roth made a point about the private sector. If you have ever been in the jaws of some of these accounting systems with credit card companies and so on, you are not very impressed how these systems work, either.

But one of the things that concern people about government is that you can't ever seem to get accountability. When somebody screws up, especially when they do something to violate confidentiality requirements, they ought to lose their job. There ought to be accountability some place.

I made that point with the DOD audit that was presented by you in July, and the same thing is true here. If people misuse financial information of taxpayers and they work for the IRS, they do not need counseling. They just need to be relieved of their job quickly and, if it is appropriate, they ought to be criminally prosecuted.

I would like to try to get to the bottom of understanding what the management sanctions are. Most importantly, on the behalf of the American taxpayers, we need to understand what the dimension of what happened here is and how we correct it so that it does not happen again. I hope as we explore this, we will——

Senator ROTH. Would the Senator yield just for a comment?

Senator DORGAN. I yield.

Senator ROTH. It does seem to me you are asking some good questions. The other side of the coin is what can be done under the personnel procedures and law. We can talk about firing someone, but we have rightfully built in some protection for the individual employee. So I think my question would be what can they do? Can they be fired? If so, how difficult is the process?

Mr. BOWSHER. I think Senator Roth raises a good point. I do not know the specifics of this case, but I suspect that one of the problems they are up against is some of the personnel safeguards, so I will take a look at this. I will take a look at it, because I think it would be a good case study.

Senator DORGAN. If we have a system in which IRS people misuse taxpayer information and we cannot fire them, we have the goofiest system in the whole free world, and we need to change it right quick.

Chairman GLENN. You promote them and get them in a different job. [Laughter.]

Senator Pryor has to leave and he indicated he had one quick question here before I go on.

Senator PRYOR. I do not have to leave, but I do have a question. But if Senator McCain——

Senator MCCAIN. Go right ahead.

Senator PRYOR. I am also going to ask this to the Commissioner in a moment: The letter written to Senator Glenn, as Chairman of the Committee, by Mr. Goldberg, on February 20, 1990, in which he promised the Treasury Department's Inspector General will provide independent and ongoing oversight of IRS inspection, etc. The second commitment was to provide additional outside review—the formation of the Commissioner's Integrity Review Panel.

Would you comment on those two commitments that Mr. Goldberg made? (1) Did the Treasury Department's Inspector General have ongoing review? Was that followed through with? (2) Did the Commissioner's Integrity Review Panel function, was it formed, and is it still in service?

Mr. BOWSHER. I will have to check on that, Senator, because the truth of the matter is we do not know right now. I would have to go back and get a copy of that letter and find out those two points, and we will do that.

Senator PRYOR. Thank you, sir.

I want to comment about counseling for the IRS employees. I think that counseling ought to be for the poor taxpayers who has had their confidentiality and privacy violated. But that is just a little comment I would have on that particular area.

Thank you, Mr. Chairman.

Chairman GLENN. We will start the next round. I think we have a vote coming up at 11 o'clock.

Mr. Chapin, after having on July 1st been in the same seat you are in right there testifying about DOD and the Army's condition, I am not sure I would call out the Army to do this audit. They have their own set of problems. [Laughter.]

Mr. BOWSHER. I think you have a point.

Chairman GLENN. I do not know who you are going to call out, but let's not make it the Army, until they get some of their own problems straightened out.

Mr. CHAPIN. Senator, you make a very good point. I just have an urge to say something that is in order for this hearing, and that is that the Senators this morning are appalled at the treatment of taxpayer records and have raised the question of discipline of IRS employees, to follow the rules.

I wish that across government people would follow the rules, do what they should do, follow the policies, follow the procedures. We would not have half the problems we have now, if we would just do what we were supposed to do, if there was discipline in the system. The thing that is lacking in the Army audit, clearly major improvement could be had almost overnight, if the people that are running the business side of the Army were as disciplined as the people out there fighting our wars. We have just got to get discipline back in our system across the board, IRS, every place.

Senator MCCAIN. Mr. Chapin, I do not disagree with your comment at all, and I think it is a nice statement. But there is something unique about invading the privacy of a citizen and that is why the Members of this Committee are alarmed. We do not disagree with anything you say, but invasion of privacy is something that is a fundamental protection against which every citizen should be insured.

Mr. BOWSHER. We agree, Senator.

Chairman GLENN. Mr. Bowsher, GAO's audit identified improper and unsupported payments by IRS to vendors. As a matter of fact, your sample of 280 payments to commercial vendors found 32 improper payments. That is over 10 percent of the sample. How much money is involved here, and is this a major problem?

Mr. BOWSHER. Well, it is a major problem, because it indicates again the lack of good procedures, the lack of discipline on how you pay out the taxpayers' money for payments. I think you can see in one of the illustrations there the documentation indicated that it was a credit, rather than a payment that was due.

I think one of the most disturbing parts of that sample that we took was the lack of support. In other words, one of the basic things in an accounting system is you do not pay bills, unless you have the proper documentation to support that this is a payment that should be made.

As I said in my opening statement, the IRS, when they go and examine taxpayers, they require support for disbursements that you list as a deduction, and they will disallow it, whether you are a business or an individual, if you do not have the proper support. So there is no reason why the IRS or any government agency ought to be making payments without adequate support for those payments.

Chairman GLENN. Let me get back to one we hit on a little while ago here, because I am not sure that Senator Roth got the information he wanted, and I am not sure I did. Your audit of IRS suggests the agency, contrary to legal requirements to do so, cannot provide detailed information on specific taxes it has collected.

IRS distributes general revenue funds to the excise tax trust funds based on tax assessment, instead of actual collections. Since assessments exceed collections, this practice effectively results in inappropriate subsidies from the general revenue fund to the excise tax trust funds.

Now, we are concerned, obviously, that past rate decisions may have been different, had Congress had information on actual excise tax collections. Is this a major problem, the size of the subsidy, and how should this new information impact tax rates?

A while ago when this came up, I noted that Ms. Richardson was shaking her head back there "no" on this, at some comment that was made up here, and I wanted to come back and revisit that, so we get your proper assessment of that. I think she may have a little different view of it.

Mr. BOWSHER. Again, you would hope we would have an accounting system that could give you a proper accounting of all the revenue that came in and how much belongs to the Social Security Trust Fund, how much belongs to the different excise taxes, how much belongs to just general fund receipts.

Chairman GLENN. Are we subsidizing Social Security out of general revenues, then?

Mr. BOWSHER. That is what we believe is happening.

Chairman GLENN. By how much?

Mr. BOWSHER. Well, several billion dollars, probably. Again, it is an accounting entry over there. In other words, whatever money is coming in is being accounted for and deposited at the Treasury. But if you would think of a profit and loss statement in the private sector, let us say, and you had your sales breakdown and so much came from general sales, so much came from excise taxes, so much came from Social Security taxes, what we are saying is that breakdown is not accurate.

In other words, what we are saying is that the system you have today is giving you information that is forced, that is they are trying to give the right amount as they view it to the excise taxes and to the Social Security Trust Fund, but whatever has been left over is then shown as general fund receipts.

Chairman GLENN. Do we think it is several billion dollars actually being paid, or is it that we just do not know?

Mr. BOWSHER. We think it is several billion dollars, but we cannot give you an accurate figure.

Senator ROTH. Could I just interrupt, Mr. Chairman?

Chairman GLENN. Yes.

Senator ROTH. If I understand what you are saying, when you use the word "subsidy," what you are saying is that the government makes up from general revenue what purportedly is not being collected. If we were collecting what we should, these funds would be flowing to it. So it is a failure of collection enforcement, really, is what we are talking about, and it has been the decision to make that up. But I think it is important to understand that, essentially, it is not a subsidy in the normal sense of the word.

Mr. HOLLOWAY. I think you have to make a distinction, though, because that is true in the case of Social Security, because the law requires that you pay what gets credited. In the case of many of the excise tax trust funds, you are only supposed to distribute what actually got collected, so that is a little bit different, because, technically, one could argue they are in violation of law, because what they are doing is paying based on the assessment, which is a function of the——

Senator ROTH. The bottom line is we don't know where we are.

Mr. HOLLOWAY. That is probably a fair statement.

Chairman GLENN. We are going to have to move along here, because we are going to have to vote shortly, and we have other witnesses, and Ms. Richardson I am sure wants to respond to a lot of these things, too, and we want to get her testimony in, also.

I do want to ask one other question, and that is on receivables. Now, we have gone all over the lot on receivables for the last 3 or 4 years in your testimony and in IRS testimony. We have gone, as I recall, from $109 billion out there that was supposed to be owed the government, of which $60-some billion—I do not know what the current sum is, but $60-some billion were collectible, we thought.

Mr. BOWSHER. About $65 billion.

Chairman GLENN. Now, under this new audit, we find out that really what we mean is that there is $22 billion really honest-to-goodness out there that should be collected. Why can we not collect that, in your opinion? Why isn't IRS doing that? We are talking about $22 billion that is out there waiting to be collected.

And we go over in the conference over here on reconciliation and we are fussing over a few hundred thousand her or a million here or there, and here we have $22 billion out there that is actually owed and collectible. Why is that not being done?

Mr. BOWSHER. Well, some of it is being done. One of the problem in the past is you did not have your records in good enough shape to really know what was the money that you should be going after with the hardest effort, you might say. You did not have it aged like most organizations would have receivables aged and just have the proper information. Some of the reason, also, of course, it is being paid on installments.

So you have some reasons here, but I think now that we have a much better handle on this figure and information, I think the IRS will have a much better ability to try to collect what is collectible. Of course, a lot of these receivables historically, where we got those high amounts, were a combination of errors of amounts being booked, but also a big effort was not really being made to figure out what was the real collectible amounts receivable and to get the right information out to the organization to go after it.

Chairman GLENN. My time is up. Senator Roth, we just checked and the vote is on at 11 o'clock, so we will have to go over there and vote in a few minutes.

I think what we are going to have to do, the Customs people I know are here and waiting this morning. I think we are going to have to put that off, because I know by the time we come back from the vote and get Ms. Richardson on, we are going to be way over time here.

I hate to have wasted your time this morning, those of you from Customs that are here, but I think we are going to have to put that off until another time. And staff can work with them, if we can get together and reschedule a time on it. I hate to do that, because I know you have spent your whole morning over here.

Senator ROTH. I have no further questions.

Chairman GLENN. Senator Pryor.

Senator PRYOR. No questions.

Chairman GLENN. Senator McCain.

Senator MCCAIN. No questions.

Chairman GLENN. Senator Dorgan.

Senator DORGAN. One quick question: What is the basis for your judgment about how much of the accounts receivable are collectible? The IRS uses what they call queues, I believe, and they put certain accounts receivables in a queue. This system has not worked because the IRS does not have enough collectors. But how do you come up with an assessment of what is collectible?

Mr. HOLLOWAY. It is exactly the same way they do it in the private sector. Basically, you go in and you make an evaluation on the best available information they have on the taxpayer, to try to determine, based on their paying ability, based on their assets, based on what is owed, based on their history, how well they paid.

I might add that when we did that collectibility assessment, we had a better than 90 percent concurrence rate with the IRS as to the estimates that were made as to what portion of those amounts were collectible. So it is really a judgment call, simplistically stated.

Senator DORGAN. Mr. Chairman, there is a serious problem with a lack of data on accounts receivable and so on, and I understand that.

On the other hand, the tax agency also has another problem with the way people interpret accounts receivable data. Accounts receivable might also include provisional assessments, which no one expects they will collect 100 percent of, that inflate the accounts receivable. So it is important to understand what the accounts receivable number represents. The fact that the IRS has as high an accounts receivable number as it does from time to time does not necessarily mean they are mismanaging. What they are doing is including provisional assessments even though they will later settle for less, with more information being developed in the audit or subsequent administrative action.

Thank you, Mr. Chairman.

Chairman GLENN. Just one other comment before we change witnesses here. Back several years ago, some of your testimony and that of the people from OMB led us to ask GAO and OMB separately to put the high-risk list together and prioritize those, so that we could have hearings and try and prevent another S&L or another problem. And we came up with the fact that the total potential government liability from all guarantees and from all sources, loan programs and so on, is around $6 trillion total, as I recall.

Mr. BOWSHER. That is right.

Chairman GLENN. And we hoped that we could protect as much of those liabilities as possible, by knowing in advance about what the high-risk areas are.

Now, OMB went to work and put together their list, you put together your list, and we sort of combined them, and it has become somewhat of a guide for us here. We have seen the press pick up on this a little bit and concentrate some of their writing in high-risk areas.

Is it possible, since under the CFO Act the responsibilities for these audits are split between GAO Inspectors General that also report to the proper committees on the Hill——

Mr. BOWSHER. And some are being done by CPA firms, too, Mr. Chairman, so there are three groups doing them.

Chairman GLENN. Is it possible that we could make a rating system? What I am thinking of doing is keeping pressure on the agencies of government and compare progress. If Interior is way ahead of somebody else, maybe Defense is way behind, and we publish a list once a year that is like the high-risk list, we say who is doing a good job of financial management, and who is doing a lousy job.

I don't know if we put a school report card together for them, A to F. But would it be possible, with the split responsibilities, to do a rating system like that? So as we monitor agencies over the next 3 or 4 years, you can tell us here are people making real advances, here are people that are doing lousy, we need more attention to this. Then OMB gets the message and they start putting the heat on people. Is it possible to put together a rating system like that? Let's give them report cards.

Mr. BOWSHER. I think a status report like this, which we could put together, coming to the Committee would make a lot of sense. And I think on an annual basis you could take a look and see where the progress is being made, where no progress is being made, and somewhere in between, and I think it would give you a good indication of the very thing that Senator Roth is concerned about, how much progress are we really making and are we going to get there. And that is, basically, to have audited financial statements of all the large financial entities of the Federal Government and to get these systems in good shape.

Let me just say one thing again here on the IRS and Customs: Both of them have started programs to get on top of this and I think it would be good to monitor that on an annual basis, and we can certainly do that for all the other major agencies, too.

Chairman GLENN. And if one agency is doing good and is moving up on your scale here, other agencies are going to want to go over there and see how they are doing it and learn something from it.

Mr. BOWSHER. That is right.

Chairman GLENN. I think this would be a good system.

Mr. BOWSHER. I think it would be a good effort.

Chairman GLENN. Could you give us a letter back on that?

Mr. BOWSHER. Sure.

Chairman GLENN. I am not asking for a huge study, but could you get together with some of the other IG's that are doing some of the other auditing and see if we could not work out some cooperative arrangement for doing a rating system?

Mr. BOWSHER. Yes, we would be pleased to do that.

Chairman GLENN. Good. If you could give us a letter back, I would appreciate that very much.

Mr. BOWSHER. OK.

Chairman GLENN. Thank you. We may have additional questions in writing for you. We would appreciate an early reply on those. You have been here a long time this morning. Thank you very much.

Mr. BOWSHER. Thank you.

Chairman GLENN. The next witness is Margaret Richardson, Commissioner, Internal Revenue Service.

Ms. Richardson, we are very glad to welcome you this morning and we will go ahead with your statement at least until the bell goes here to call us over to vote.

Commissioner Richardson is accompanied by C. Morgan Kinghorn, Chief Financial Officer or CFO at Internal Revenue Service, and Michael Dolan, Deputy Commissioner, Internal Revenue Service.

You have heard a lot this morning. I have seen you nodding in agreement a few times and your head going in the other direction indicating disagreement a few times, so we will now look forward to your statement, Ms. Richardson.

TESTIMONY OF MARGARET MILNER RICHARDSON,[1] COMMISSIONER, INTERNAL REVENUE SERVICE; ACCOMPANIED BY C. MORGAN KINGHORN, CHIEF FINANCIAL OFFICER; MICHAEL P. DOLAN, DEPUTY COMMISSIONER, INTERNAL REVENUE SERVICE; AND ED VERBURG, CHIEF FINANCIAL OFFICER, DEPARTMENT OF THE TREASURY

Ms. RICHARDSON. Mr. Chairman and Distinguished Members of the Committee, first I would like to ask permission to include the longer statement that we provided to your Committee.

Chairman GLENN. Your statement will be included in the record, without objection.

Ms. RICHARDSON. I will just summarize some of the things that are in that statement and then be pleased to answer questions.

I am pleased to be here today to discuss financial management at the Internal Revenue Service, the preparation and audit of financial statements as required by the Chief Financial Officers Act of 1990, and the actions that we at the IRS are taking to ensure the successful implementation objectives of that Act.

With me, as you noted, are Mike Dolan, who is the Deputy Commissioner, and Morgan Kinghorn, who is our Chief Financial Officer-Designate. Ed Verburg, who is the Deputy CFO of the Treasury Department is also here with us today.

I particularly welcome the opportunity to appear before you for the first time as Commissioner of Internal Revenue, and I want to commend you, Mr. Chairman, and your Committee for sponsoring the CFO Act. We at the IRS view that Act as a powerful management tool, and the audit of our fiscal year 1992 financial statements by the General Accounting Office has provided us with a baseline by which we can measure improvements in financial management at the IRS. We view that audit as the keystone for our efforts to provide full accountability for financial management to the President, to the Congress and to the American people.

Today, I would like to focus on three matters, financial management at the IRS, the GAO's audit of our 1992 financial statements and the steps that we have taken to implement the CFO Act.

Before I get into that, though, I want to note for the record that I, too, share the concerns expressed by the Committee members about integrity and confidence in the tax administration system. As you know, Mr. Chairman, I am a former employee of the Internal Revenue Service, and I feel very strongly about protecting the integrity of our tax system. As I told you yesterday, we at the IRS will not tolerate anything that will impinge on that integrity or the credibility that the American people place in the system. In a few minutes, I will get into more specifics about the IDRS issues, but I do want the record to reflect my concern.

Chairman GLENN. Fine.

Ms. RICHARDSON. The IRS has a strong tradition of working closely with the General Accounting Office in reviewing our operations to improve management, including our financial management practices and to enhance our accountability.

As Mr. Bowsher indicated, in 1988, after a 2-year general management review, which was really an unprecedented joint effort be-

[1] The prepared statement of Ms. Richardson appears on page 284.

tween us and the GAO, the GAO issued a report, a portion of which was devoted to recommended improvement in financial management. All of those recommendations have been adopted and implemented.

As GAO noted in its 1992 audit, since the issuance of that general management review report, we at the IRS have made important strides in addressing long-standing financial management problems. In my written statement, I describe in more detail the many steps that we have taken to address those long-standing financial management problems. They include establishing the positions of a Chief Financial Officer and a Controller to provide financial management leadership.

We hired a Controller, Morgan Kinghorn, who is now going to be the CFO. He has had 20 years of financial management experience outside of the IRS. We have also enhanced our financial management expertise by bringing in a number of people from both inside and outside the IRS and from outside of the government who are experienced in accounting, budgeting and financial management.

We have installed a new automated financial management system. We have developed a cost management information system, which will be part of our automated financial management system, which will provide information on the costs of doing business to managers who must make decisions on how best to run their operations.

I believe that we have made a lot of progress in the last several years, particularly since 1988. However, I also recognize, as I think several people here this morning have noted, we still have a lot that we have to do. But I want to assure you that the IRS has made the commitment, I have made the commitment, and we are now making the required effort to improve our financial management processes and to fully comply with the CFO Act.

We view the GAO audit as an opportunity to improve our performance and our accountability, and we truly appreciate the advice and counsel that the GAO staff gave us. That audit has already had a significant impact on the IRS. While we had already discovered and we were addressing many of the issues that are reflected in that audit, the audit did cause us to review carefully the entire financial management program at the IRS.

The findings of the audit provide the baseline against which all of the changes in our financial management systems will be measured, and I can assure you that the many recommendations that came out of the audit, both the formal and the informal ones, are being aggressively pursued throughout the IRS.

The significant matters noted during the audit by GAO relate to program areas of revenue accounting, to tax accounts receivable and to seized assets, and to administrative areas of property and equipment, management of operating funds, computer controls and reports that are required by the Federal Managers Financial Integrity Act.

My written testimony outlines the steps we have taken or we will be taking to address most of the major findings, but I wanted to summarize just a few of them for you, to give you a flavor of what we are doing.

To insure accountability over property and equipment, we are completing a total physical inventory of our automated data processing equipment and the reconciliation of the cost of this equipment with acquisition documents. We are currently finalizing our operating procedures to strengthen guidance to all our employees on maintaining the accuracy of inventory records.

Several years ago, we recognized the deficiency in our administrative accounting systems. To address those deficiencies and to provide management with information that is needed to make informed decisions, we installed software for a fully integrated accounting and budgeting system in 1991, and we have implemented it throughout the Service at the beginning of this fiscal year 1993. That system will provide data necessary to prepare accurate financial statements and the controls necessary to effectively manage spending, to ensure compliance with congressional mandates regarding the use of appropriated funds.

During the course of the audit, we provided GAO with a report by our own internal audit staff, as has been noted, on the security of our Integrated Data Retrieval System, known as IDRS.

As has been pointed out, IDRS is the largest database of taxpayer accounts that is accessed by IRS employees in the performance of their duties. We have approximately 56,000 authorized users nationwide and the system processes in excess of 100 million transactions a month. Although the system is over 20 years old, it has virtually all of the security features that are required by the National Institute of Standards and Technology for systems that process sensitive information.

My statement goes into all of the security features, and I thought I might highlight just a few for you here. All the users are assigned a user identification number and a password. The identification number includes specific data that identifies the individual user, the location, the branch or organization they belong to.

Passwords are used in addition to the identification number and authorized users are profiled for access to only certain command codes, based on the type of work being performed. In addition, each of the IDRS terminals has unique identification, so that the audit trail for every transaction not only identifies the individual, but the specific terminal that he or she uses. System access requires management review and approval, including performance of a background investigation.

Mr. Chairman, as I mentioned to you in our conversation yesterday, the IRS has always had strong policies and procedures in place to allow only authorized employees to access taxpayer accounts, and we have and we will take disciplinary action where abuses were or are found. Such activities will not be tolerated, as I told you yesterday.

As a result of our own internal reviews, we have taken steps to put greater management emphasis to ensure the safeguarding of the privacy and security of taxpayer information. Ethics, as you know from prior encounters with some of my predecessors, is one of our five major business strategies. Embedded in our ethics training, which is mandatory for all employees, is the necessity to protect privacy of taxpayer data, and specific situations related to IDRS security are included in our service center training materials.

While the GAO's financial audit has focused attention on the security of IDRS, the IRS, as a result of our own Internal Audit Report in 1989, took the initiative to put in place an automated way to monitor employee access of IDRS. It was that security system database that we put in place that provided the audit trail information on which the Internal Audit Report was based and which allowed us to perform the extensive reviews of IDRS which resulted in the detection of inappropriate use of the computer system by a few of our employees.

I want to emphasize that the use of IDRS in an unauthorized way by even one employee is intolerable, but I think we need to put in perspective the number of employees that we have identified thus far who have abused their authority, and I would feel very uncomfortable if people left today thinking that every one of the 115,000 employees of the IRS is browsing randomly through our IDRS database.

The growth of the user base since the introduction of IDRS 20 years ago has resulted in the significant volumes—I mentioned over 100 million transactions per month—and that means we have to develop new systemic ways to monitor the activities that take place in our computer system database.

Many new security features are being incorporated into the design of our Tax Systems Modernization program. But in the interim, we have initiated an effort to enhance our ability to review the audit trails, utilizing new technology.

The new technology allows for computer-assisted analysis and tracking of transactions, and it facilitates the identification of inappropriate trends of activity and access. This capability will allow our security analyst staffs to monitor all activity thoroughly and to detect inappropriate use. The technology is currently being piloted in the Southeast Region, and we anticipate that it will be installed in the remaining regions in early 1994.

I think that the comprehensive review of IDRS security that you discussed earlier with Mr. Bowsher is one that I would like to volunteer that we will undertake along with the GAO and report back to this Committee.

Also, I think it is important, Mr. Dorgan, that we do review our training practices. I have been on the job about 2½ months, and I have to confess that although the issue of IDRS security is something of the very highest priority, I have not done a comprehensive review myself of all of the procedures and concerns that were raised in the Internal Audit Report relating to IDRS.

But I will pledge to you that we will undertake such a review, working with GAO, with the Inspector General at Treasury, and with our own Internal Audit staff, and we will report back to you at the earliest possible time. I think I would like to sit down with Mr. Bowsher and work out the details of how we can go about doing it and what a realistic time frame would be. But I do want to emphasize that I view this as the highest priority and that I, too, am impatient about finding the answers.

Finally, in response to GAO concerns about the strength of our internal control oversight program, including those that are required by the Federal Managers Financial Integrity Act, we have consolidated all of our staffs into one office under the CFO, and we have established a Senior Council for Management Control, which is chaired by Mike Dolan, the Deputy Commissioner, with the Chief Financial Officer as his Deputy Chair.

They are charged with assuring that our internal control programs are in place and, more importantly, that they are working, and I can assure you that I will be holding them accountable for assuring that the corrective actions taken are working.

We at the IRS are not only committed to implementing provisions of the CFO Act, but we have also made a commitment to ourselves, and we will make it to this Committee, that we want to serve as a model for financial management improvement for the entire Federal Government. After all, I think if we are asking taxpayers to keep proper records and to be financially responsible, we should do the same.

The Act and the audit it required have really allowed us the opportunities to see the totality of our financial management concerns for the first time, and this has and will, I think, enable us to better plan for solutions and to manage their implementation.

In addition to allowing us to see the big picture, if you will, the preparation and the audit of our 1992 financial statements afforded us the opportunity to establish an open working relationship with our counterparts at Treasury, the Office of Management and Budget and the General Accounting Office, and I think it has fostered a better understanding among all of those folks about what we are doing and a better understanding of our programs and our objectives.

It has also, I think, helped us to begin to change our corporate culture, one which traditionally, like much of the Federal Government, did not emphasize financial management. We are now looking at our accounts receivable as a Federal corporate asset, not just as an IRS program function. And in response to GAO's suggestion, we have already changed the way it is reported.

We have begun decentralizing our operating budget to our field offices, a process which permits our field managers to make financial decisions, but which also holds them accountable for their management of resources.

With the progress that we have made thus far, there is a heightened awareness of financial management implications throughout the organization, a recognition of financial accountability in non-financial areas, and the integration of fiscal considerations in program decisions.

As you can see, Mr. Chairman, we are serious about identifying the weaknesses in our financial management systems and we are equally serious about correcting them. We have taken actions in many areas, both in tax administration and in the management of our operating funds, that we think will address these weaknesses and ensure much better audit results in the years to come.

But we think the real solution to fulfilling the spirit of the CFO Act and to upholding our commitment to serve as a model for financial management is a corporate commitment to continued improvement by everyone at the IRS.

As I mentioned, we have undertaken a major reorganization of the Service and, among other things, we have consolidated financial management programs and systems under the CFO. The CFO is now one of six senior executives of the Internal Revenue Service who will be reporting directly to the Deputy Commissioner and to me, and the CFO has the responsibility now for overseeing revenue accounting and reporting accounts receivable, monitoring internal controls and the follow-up on financial audit corrective actions. We have broken that function out from our other administrative functions and assigned only the financial accounting responsibility to one person.

We also are fully implementing a cost management system which will provide component costs of our operations to help managers make better informed financial management decisions. It will help them make better informed program decisions, as well, by letting them know the costs, the value added and the outcome of those decisions.

To better manage our operating funds, we are looking at various options for streamlining our payment operations, and we are redesigning our revenue accounting and reporting system to ensure that the information we provide to the President, the Congress and the American taxpayer is more consistent with the financial statement reporting requirements of the Act.

Finally, as you know, we are in the initial stages of a Tax Systems Modernization program, a program which affords us the opportunity to make major improvements in tax administration by reinventing the way we do business. We believe that the audit report highlights the necessity for implementing Tax Systems Modernization at the earliest possible time, and I think much of the testimony here this morning emphasizes that importance.

Mr. Chairman, these are ambitious plans, but I have been assured they are not unreasonable ones. With the continued support of this Committee, the Treasury Department, the Comptroller General and the Administration, I believe that the impetus provided by the Act can be successfully extended and expanded.

I understand the amount of progress that is still required, but I want you to know that I intend to work as hard as I possibly can to ensure that the IRS does receive a clean opinion on its financial statement and, hopefully, it will not take 3 years. I do not underestimate the organization-wide effort that is required to make this happen, and I do not expect overnight miracles.

I do believe, however, that achievement of this objective is key to maintaining the taxpaying public's confidence in the tax system and those of us who administer it. I think you have a right to hold me accountable for following through on the issues that were raised in the financial audit, just like I expect to hold the people working for me accountable.

I am going to give you the same assurance that I have given to Secretary Bentsen, and I think you all know from your dealings with him through the years, he is extremely interested in fiscal integrity and in financial management in the government, and I have told him that I will be accountable and have given him the assurance that I will follow through, to see that we have taken steps and that we will continue to take steps to assure that we will get a clean opinion, and not just to get a clean opinion, that we will do things that I think are fiscally responsible and sound.

That concludes my remarks, Mr. Chairman. We would be happy to answer any questions.

Before I do, however, there is one matter that I might address, since it came up several times. That was the question concerning Social Security and excise taxes, and you mentioned that I was nodding my head in disagreement, at least with part of what was being said.

There are two different issues. Social Security payments or payments to the Social Security Trust Fund, by law, are made based on the wages that are reported, not based on the taxes that are collected. Therefore, our accounting and our payments to the Social Security Trust Fund are done in accordance with the legal requirements. I think you properly identified whether or not the policy issue needs to be addressed by Congress, but the way we at the IRS reflect Social Security payments is in accordance with the law. It is not based on the amount paid in for Social Security taxes. It is strictly based on wages.

Chairman GLENN. I realize that. That is not the question here. The question was whether the accounting system at IRS is such that you can tell us exactly how much actually comes in, not just the assessments, but is actually collected and what the amount coming out of general revenue to supplement Social Security is. I think that is what Mr. Bowsher pointed out, that the accounts were such that he could not figure out what it was.

Ms. RICHARDSON. On the excise tax front, I think that is what he was pointing out, not on the Social Security front. For example excise taxes, he is correct, we do not have accurate reports on the amounts that are actually collected.

Chairman GLENN. Let me ask a very basic question here to start out with. I do not have any doubt at all that you are committed as anyone can possibly be committed to correcting the situation that we are in.

We find that in some administrations, though like in the past 12 years, 50 percent of the political appointees were gone within 27 months and 31 percent were gone within 18 months. Are you committed to staying through the administration?

Ms. RICHARDSON. I have assured my staff I will be here for 8 years, sir. [Laughter.]

Chairman GLENN. Good. I am glad to hear that. You have 7½ years to get all these things worked out. That is fine.

Ms. RICHARDSON. That is right.

Chairman GLENN. I want to give credit where credit is due. IRS started some of their own internal looking at these problems back in 1990. That is fine. They have turned up a lot of these problems themselves, to their credit. As you point out, we have 115,000 employees in IRS, most of whom are doing a fine job, just as dedicated as any other people in existence to doing the finest job they can do, and I want to give them credit.

But when you have one region that has some 369 people at least under a cloud—I will not say to what level here, but at least under a cloud—being investigated. As I've said, almost 5 percent of the people in that region have access to these codes and so have some sort of question raised about their performance.

Now, it makes me wonder, when we have seven regions, is that correct?

Ms. RICHARDSON. That is correct.

Chairman GLENN. We have seven regions and we have only looked, I guess, at one code so far out of 56 total, and I do not believe we have gone into the other regions with the same sort of analysis we did in the Southeast area. Why on earth is it taking 3 years to get into something which is so fundamental to belief in the system by the American people? How long is it going to take? If we turn up something like this, it would seem to me the red lights would go on all over the system, your predecessors would have jumped on this and gotten action to this, so we know exactly what is going on all over the IRS and gotten it straightened up, and that should not take 3 years.

Ms. RICHARDSON. Senator Glenn, I am going to ask Deputy Commissioner Dolan to respond to that, because not only is he the Deputy Commissioner, he was in the Southeast Region when they began these activities were discovered.

Mr. DOLAN. First of all, for good or for bad, I was in the Southeast Region when the Regional Inspector brought to me an issue, a suspicion at that point that there was a concern in terms of the use of this command code. This command code we have talked about today is something we call REINF, which is immaterial in name, but I think in terms of addressing some of the concerns raised, what that command code does—it is a fairly generic command code to which a lot of people would have access—what the command code does is allow you strictly to access in a read-only mode an increment of data that says Mike Dolan's return has been posted to the master file, he is going to get a refund, it is "X" amount and it is due out on "Y" date.

And there was a concern that the Regional Inspector had, at that point, that there was some possible monitoring of refunds that might in fact be collaborative with other kinds of misconduct, and so what he did was he undertook an effort that in the initial effort was a very comprehensive one. Because what he had to do was sort through everybody who had used that code, and he did a number of different distillations. He looked over a 3-year pattern. He looked at somebody who has accessed Mike Dolan's return 3 years in a row. He looked at whether somebody has accessed Mike Dolan's return repeatedly during the last month. He looked for a number of different distillations, from which he then drew down this 300-some person sample.

Of that, Senator, I think as you may well know, a percentage of those instances turned out to be, in fact, people who did not have any reason to access Mike Dolan's return. But unlike some of the concerns expressed on the part of other members, that information was not taken anywhere, that information was not used either for personal gain on the part of the employee or in any detrimental way to the taxpayer. It should not have been done, because the person had no authorized basis to inquire about Mike Dolan's refund.

But the limitation of that command code was in one sense good news and in another sense it was problematic, because exactly the concern you raised was what we raised. Looking at a research command raises all kinds of questions about the more substantive commands, what about the command codes that allow people to adjust accounts, what about the command codes that allow people to change addresses.

So what actually happened from the Southeast is, in the Southeast Region we made, I think, a very complete reaction to what we found there, shared that with both inspection and management channels with other regions. In fact, three other regions have done an almost similarly comprehensive, not over 3 years, but the same sort of review of that command code. But I think maybe, most importantly, what we did was learn some things in Southeast that allowed us to put solutions in place elsewhere and not go through the whole drill.

For example, we did refresh the employee training, we did set new expectations for line managers, we did recast the annual business plan, we did in fact establish a table of penalties so we would have consistent discipline.

Chairman GLENN. What led them to do this? Was this just computer voyeurism of some kind? Is it titillating to get into somebody's account and figure out that some movie star makes whatever? Is that the idea?

Mr. DOLAN. I think one of the things we found—it goes to one of Senator Dorgan's questions and he may come back later and want to re-ask it, the question of counseling versus other possible actions. When you look at the reorganizational reaction, we have done everything from removing a few people, to suspensions, to reprimands. We have done what is called an oral admonishment, and we have done counseling. That is essentially the table, the gradation of penalty.

At the admonishment and counseling level, typically what we had was somebody who we asked why were you in this account, and they had no way of remembering what it is that might 2 or 3 years ago have caused them to go to Mike Dolan's account. In some cases, it might be an attempt at helpfulness, somebody calls them and says I need my refund, is it on the way. They should not have done it, if they have not come through the normal taxpayer service gates. But I think beyond that, it would be hard for me to speculate what the motivations were.

Chairman GLENN. It is awfully hard for me to believe that this is just titillating to them to dip into somebody's computer account or something. Here you have 5 percent of your people doing that in Southeast.

Mr. DOLAN. I think, in point of fact, the sample may have been close to 5 percent. Again, as the Commissioner said, if you have one, it is one too many. But I think the ones we actually took action on were about 150 and that included the counselings and the admonishments, but there was never really any ascertained wrongdoing.

Chairman GLENN. How do you track down, though, where you had at least one case where there is a person who really went in, altered accounts, got special refunds and may even have kickbacks for getting that? Now, how do you protect that in the new system, and how do you prevent hackers in a new system from doing the same thing?

Mr. DOLAN. That, of course, is the part that is of most interest to us, as well. One of the things we have, Senator, as I think you probably well know from your involvement in TSM, is we have a system today that really makes us do all of our security prevention in a one-dimensional way.

We do it, as Mr. Bowsher and others have described, by attempting to essentially code Mike Dolan's access. So I get a password, I get a taxpayer number, I get an employee number, I get a terminal identified to me, I work in a group that has a profile about how much action I can take, and then I get an individual profile, but it is all personalized.

Essentially, once I get equipped with my number and with my terminal and with my profiles, any work in which I would use those profiles is in fact legitimate. In the TSM world, the world that we want to get to, we will be able to control both by accounts, by the taxpayer and the employee, in a way that we cannot do today. We have a system that originally, when IRS started out with it, had three or four pieces of data on it.

It had if there was a delinquency, and today, a million times a month, we are trying to do everything from respond to the taxpayer who says I did not get my refund, can you change my address, to somebody who says I got a CP2000 from you for some income, and all this is done off IDRS. It was never done there in the past. It is a huge change.

Chairman GLENN. My time is up. Just one more question, David, if I might, before I go to you.

Senator PRYOR. Oh, certainly.

Chairman GLENN. Why has it taken 3 years to run the same kind of detail analysis in all seven regions? Why is it just in one and why is it not to all the codes? You have 56 codes.

Mr. DOLAN. Actually, what we have done, Senator, as I mentioned, is in three regions we have done something very similar to what was done in Southeast on that one command code. There is also in Southeast about to be completed a similar review that was done on an adjustment activity code which we thought to be among the most sensitive. There are several more that the internal audit activity has scheduled to be done as national reviews, done in one region, but extrapolated across the country, and those are all queued up in their business plan for the upcoming fiscal year. So it has been a series of attempted reactions to what we learned in Southeast.

Chairman GLENN. My time is up and we are on a vote, so we are going to have to run shortly.

Go ahead, David.

Senator PRYOR. Thank you, Mr. Chairman.

Chairman GLENN. I will go ahead and go on over, and then I will get back so we can——

Senator PRYOR. I will wait for the second bells.

Chairman GLENN. Fine, and then recess.

Senator PRYOR [presiding]. Mr. Dolan, when was it that you first noticed that there was something in the command code that was sort of out of kilter or different than it had been? When was that?

Mr. DOLAN. I believe, Senator, it was in the late 1990-early 1991 time frame that the Regional Inspector first raised his concerns with me.

Senator PRYOR. Now, was that reported then to the Inspector General?

Mr. DOLAN. I cannot answer whether it went to the Inspector General. I know it was reported within the Inspection organization to the Chief Inspector of the Internal Revenue Service.

Senator PRYOR. In 1990, I have already made reference to this a couple of times, the then Commissioner, Mr. Goldberg, said that there was going to be ongoing review by the Inspector General. Also, he was forming a Commissioner's Integrity Review Panel. Whatever happened to those commitments?

Mr. DOLAN. I think the commitments were met, Senator Pryor. I know that the Integrity Review Panel was a panel of distinguished, mostly outside, persons that came in and helped then Commissioner Goldberg launch a comprehensive strategy which included, among other things, the Service's hiring on a long-term contract the Michael Josephson Institute; all line managers were trained in a program that Josephson helped us develop, and we have now completed I believe training of all 115,000 people, in the middle of which we were able to take what we learned in Southeast and put that in all employee training, such that there is an added emphasis on ID and security.

Senator PRYOR. Do you know if this panel looked at this situation that you found in the Southeast Region?

Mr. DOLAN. I do not know that, Senator.

Senator PRYOR. You do not know if it was brought to this entity's attention?

Mr. DOLAN. I am not sure whether it was brought to their attention.

Senator PRYOR. I have a list from the January 1990 interim report of those members of the Integrity Review Panel. They are distinguished people, and I will place those names in the record. I am just wondering if they were active, inactive, name only, or what role they played.

Mr. DOLAN. I can satisfy you, Senator Pryor, that they were very active in the aspect of designing the program. I am less clear on what precise information they might have had about an IDRS security phenomena that had been discovered.

Senator PRYOR. They were in fact called the Integrity Review Panel, and this goes to the very basic roots of the integrity of the Internal Revenue Service.

Mr. DOLAN. It certainly does. You may recall, Senator Pryor, that one of the things that gave the principal impetus to that group being called was a series of hearings done by the Congress in some very precise area, and that body of concern gave rise initially to the charter of that group. I really cannot speak personally to how much broader their charter was ultimately.[1]

Senator PRYOR. Thank you, sir.

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[1] "Review of Controls Over IDRS Security in the Southeast Region," appears in the Appendix on page 290.

Commissioner, may I ask you a question: If the privacy has been violated of any taxpayer, what do you think is the duty of the Internal Revenue Service to that taxpayer at this point?

Ms. RICHARDSON. I guess you gave me a preview of that question when you asked it before, so I have been thinking about the answer.

As I said before, if even one taxpayer's records have been looked at inappropriately by even one employee, that is not acceptable. I guess I am a little more concerned about whether at this point, given the fact that at least the Southeast report goes back, I think, to the 1989–1990 time period, and in some cases people may have been browsing, as Mr. Dolan said, not with anything ill-motivated, but perhaps even to help out a neighbor or something to see if their refund had been processed.

I am not sure at this point whether it would be practical or appropriate to go back and try to contact people, to try to identify the people——

Senator PRYOR. Let me at this time, Commissioner, do something everyone in the room is going to welcome, and that is to declare a 10-minute break, because I have to go vote and you will have a little more time to contemplate that question.

Ms. RICHARDSON. Thank you.

Senator PRYOR. We will be back in 10 minutes.

[Recess.]

Senator ROTH [presiding]. The Committee will be in order.

We will proceed. The Chairman will return in just a few minutes.

Ms. Richardson, let me say it is a pleasure to welcome you here today and your aides. I understand that the IRS has conducted a number of investigations in other regions, three other regions. Could you tell me what the conclusions or what the findings were in respect to those regions? Did you find the same problems and, if so, to what extent?

Ms. RICHARDSON. Senator Roth, I am going to ask Mr. Dolan to answer the question. Before I do, I wanted to introduce Mr. Verburg, who is the Deputy CFO of the Treasury Department, and he has joined us at the table.

Senator ROTH. We are very pleased to have you here, Mr. Verburg.

Mr. DOLAN. Senator Roth, in the three regions where there was a subsequent review, they were similar, and I underscore similar, because they were not identical. One of the things we did—I think in each of those 3 years, we did a single tax year's look, as contrasted with the original look in Southeast, where we did most often two, and I think sometimes three tax years. But the frequency that we found in the other three regions was in real numbers less.

We attribute that to a couple of things. We think that there was indeed a deterrent effect of the original review done in Southeast and the alerts and information that went throughout the organization about the potential misuse of the command code. But in actual numbers they were less.

Senator ROTH. So while there was some problem, it was not as serious as in the Southeast area?

Mr. DOLAN. There were not as many numbers of initial incidents, that is right.

Senator ROTH. Can you submit any conclusions for those regions for purposes of the record?

Mr. DOLAN. We certainly could.[1]

Senator ROTH. I think that would be worthwhile.

A number of Senators have expressed their interest in stern action being taken against these individuals. I think we all feel very strongly about the privacy rights of the individual taxpayer and the impact, if they lose that, they will have on the effectiveness of enforcement of the Internal Revenue Code.

Were you able to take the disciplinary actions you wanted, or did the requirements of the various rules and regulations prevent you from taking as strict action?

Mr. DOLAN. Senator, I do not think we were impeded in any way by personnel rules. When this first was discovered in Southeast, what we attempted to do on the front end, as we were identifying the cases, was to coordinate across management and across labor relations activities to make sure that we had a consistent pattern of reaction, that managers were similarly in tune with what the organization's objectives were in terms of disciplining people that needed discipline, and, to my satisfaction, we were able to take the action we thought commensurate with the offense.

I think it is important to come back to the notion that might have been created, unfortunately, at the beginning, that the vast majority or a significant majority of the instances were instances where oral admonishments or counseling was done, and the question was raised of what is counseling.

That is not something we send somebody off to. It is something we may have said to an employee; it is not clear to us 2 years later why you accessed, used this command code to inquire about the refund of a taxpayer. There may not have been any actual ill-intent documented, but we would have gone ahead and potentially counseled that person to reaffirm the fact that they had to have a business purpose to use that command code.

Senator ROTH. What were the standards or criteria you used to determine what actions should be taken? The majority were counseled.

Mr. DOLAN. If you would not mind, Senator, I would give you the exact recitation here.

Senator ROTH. Please do.

Mr. DOLAN. There were 11 resignations that occurred subsequent to the persons being identified as involved in this. There were 5 removals, there were 63 suspensions, 93 reprimands or admonishments, and 20 counselings caution letters. So in our mind, what we have done—and I would be happy to furnish for the record—we had essentially a table of penalties associated with the kind of inappropriate use that governed which of those penalties a person would be subjected to.[2]

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[1] "Results of Internal Audits on IDRS and Other Computer Security Related Issues" appears in the Appendix on page 64.

[2] See "IDRS Security Violations" in the Appendix on page 62.

Senator ROTH. You were here, I am sure, when one Senator expressed the view that if there was one violation, access was taken to one return unauthorized, that that individual should be fired.

I guess one of my basic concerns is how do we build confidence in the American people? It does not help much if they know that it was a common practice. How can we correct this dissatisfaction on the part of taxpayers that their privacy is being invaded?

Mr. DOLAN. I think, Senator, there ought to be no end or no limit to the diligence that we practice as leaders to continually reinforce the privacy that we owe the taxpayer. Back to your original question of should any violation represent a removable offense, what we found in some of these instances is that what this access afforded was exclusively an identification that the tax return had in fact posted to the master file, that it was due a refund and the refund of "X" amount would be mailed on a certain date. That is the entire data that this research command code made available to our employee.

What we found in some instances were that employees wrongfully, but, nonetheless, what they were doing was some neighbor had said I filed my return, I am looking for my refund, can you tell me when it is going to be there. They should not have done that. It is incorrect. It is something we do not want repeated. But there were a number of those types of offenses that we think we would take a good employee, reinstruct them, reequip them, retrain them and certainly not remove them.

Senator ROTH. What would you do, just for the fun of it, if the files on a celebrity, let us say, what action would—what is your standard now?

Mr. DOLAN. What I think might be more useful, Senator, is if I could supply to you for the record actual gradations we try to make.[1] As you may well appreciate, you can set the gradations out and then you can talk between the levels at the margin as to—does it flip over to removal or does it go to suspension or is it an admonishment or a counseling?

I would tell you that somebody who used access, used the command code for any personal gain whatsoever would typically be removed.

Senator ROTH. For personal gain?

Mr. DOLAN. That is correct.

Senator ROTH. What if they did it just out of curiosity?

Mr. DOLAN. Those, in my personal experience—again, I would like not to represent the universe of IRS experience here, because I have kind of given you my horseback opinion and would like to give you the more comprehensive—those would range between removal and suspension. If it was just pure browsing of celebrities and people for some idle curiosity, we have removed and we have suspended in those cases.

Senator ROTH. Let us assume I am a new Federal employee of IDRS. What will you tell me?

Mr. DOLAN. The first day you come to work for us, we will give you the rules of conduct. We will spend probably a full day trying to inculcate a variety of things important about working for the

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[1] See Insert in the Appendix on page 62.

IRS. But throughout that initial inculcation will be an emphasis on the absolute responsibility to preserve privacy, and you will annually get an update to those rules of conduct, you will certify that you have gotten them.

In your first set of training, if you come on board as a data operator, you will be told about IDRS, you will be told again and again about the use of access, you will be told about signing on and signing off, you will be told about not letting anybody else have your employee number or your log-in, your passwords.

Senator ROTH. If we are going to get the public trust, I think it is critically important that every employee in IRS understands we are not going to tolerate one infraction, one violation. I think it is a tough problem, but I think it is something that you have to have a continuing program, as you mentioned, where this is constantly repeated to the people and they see that you mean what you say.

The problem I find here, we all get upset and you people come here in the Committees of Congress, and we hold a hearing and we raise hell, and then we all get involved in something else in a few days or a few weeks later. But that cannot be permitted to happen here, because this goes to the very core of our tax system.

So I think that it has got to be made very, very clear throughout and continuing. The rights of privacy of every taxpayer is of critical importance and it is not going to be tolerated.

Ms. RICHARDSON. I made that pledge earlier, and I will renew it to you, that we will not tolerate that kind of behavior on the part of any employee.

I offered also to have a comprehensive review of how we operate our IDRS system, what kind of training we have, working with the GAO and the Inspector General at Treasury, and then reporting back to this Committee. I personally will pledge to you that I will do everything I can to see that this matter remains uppermost in people's thoughts, because I appreciate that if the integrity of the voluntary tax system and the credibility of that system evaporates, we will never have voluntary compliance at the levels that we want to see it.

INSERT FOR THE RECORD

IRS management has completed an action plan to assess the full range of IDRS privacy and security issues and implement corrective actions to reduce associated risks and vulnerabilities to that system. In addition, IRS is expanding the scope of their reviews and conducting a more comprehensive evaluation of the entire IRS privacy and security program to ensure that appropriate safeguards adequately protect all current and future information systems and sensitive information. This latter review will be completed by December 1993.

Senator ROTH. I appreciate that very much, Ms. Richardson, and I have every confidence you will do exactly that.

I would reiterate that I think it is important that the employees understand that periodically there will be reviews, so that they know this is an ongoing matter.

Ms. RICHARDSON. I think that is one of the most important things, not just in this area, but all the areas we are talking about today, is that we have ongoing monitoring, internal controls that force people to continually monitor our financial management, our IDRS security, employee integrity, a whole host of things. And I think those are the kinds of things that I think we are poised to do. We have a number of them in place, and I think that it is the responsibility of the people who are sitting here at this table today to make sure that they are monitored.

Senator ROTH. Let me ask another difficult question. Why should Americans believe that the computer network used for electronic filing of taxes is safe from invasion by hackers? Why should we presume that a hacker who can break into the Pentagon computers for fun will be kept out of the IRS computers?

Now, I think the comment was made earlier that passwords are used, but they are also used in the Pentagon. How can we assure that it is not only a problem with the employees, but others can break into it, particularly as we stress more and more electronic filing?

Ms. RICHARDSON. I think the electronic filing per se does not present a problem, as I understand it, because you do not file directly into the master file, and so if you are filing a return, but you do not have access into the master file when you are filing electronically.

There is no question that we need to continue to be vigilant about protecting the privacy and protecting access from outside or from totally unauthorized users, but I think it is important to point out that the people who were accessing IDRS had authorized codes. Now, they may not have been doing what they were authorized to do with those codes, but they were employees who were authorized to be in the system. So this was not an invasion from the outside.

In our new system, privacy and security are uppermost in our planning, and we have a Privacy Officer. We spend a lot of time on security issues. We work with outside vendors, and we will be continuing to monitor privacy and security concerns.

I would like to give you my assurance that it could never happen, and I believe that it will not happen, but I suppose in the real world I cannot tell you that it can never happen.

Senator ROTH. That is my understanding and that is what sort of scares me, is that some of the experts tell me——

Ms. RICHARDSON. We have every safeguard in place that is known to be available, and we have not had any problems.

Senator ROTH. I would certainly keep up with the latest technology.

Ms. RICHARDSON. And we are. It is not something that we take at all lightly and don't take seriously, I can assure you.

Mr. DOLAN. Actually, Senator Roth, one of the things that has limited us in where we might otherwise go with modernization is we do not allow any dial-up access to our systems today, and that is one of the things that would keep the classic hacker. In the long-term, that is a limitation on us, because we would like to be, and we will be in our new system, in a position to have our field agents be able to connect back into the major systems. But we are not in today's system able to do that and maintain the security, so one of the things that we really look for in the new system, is the ability to have that kind of remote access and not run the risk of the hacker kind of penetration.

Senator ROTH. Let me ask just one further question, Mr. Chairman.

You earlier discussed the ability of IRS employees to look at returns, but how are they able to change information to provide for the fraudulent refunds?

Ms. RICHARDSON. The accessibility permits people legitimately to go in and make changes to some accounts that have to adjust a taxpayer's account legitimately. It is a troublesome matter, because I do not think you can ever protect 100 percent against someone who has a fraudulent intent and if they are intent on subverting the system. But the people that have gotten into the system or made adjustments had the authority to be in there with those codes.

What they did with their evil intent, if you will, is something I am not sure you can ever guard against when we are dealing with human beings. But what we can do is put controls in place to detect and to educate people to understand that, if they are not authorized to access certain information that they will be dealt with promptly and severely. You know, I think continued vigilance is probably the real answer under any system you could devise.

Senator ROTH. Good luck. Thank you, Ms. Richardson.

Thank you, Mr. Chairman.

Chairman GLENN [presiding]. Where those false refunds were made, did the person that did that actually get a kickback from those people? Do we know that?

Mr. DOLAN. I do not know that, Senator. We could find that out and furnish it to you.

Chairman GLENN. Was that part of the prosecution, though, that he or she did that?

Mr. DOLAN. I think you had a combination of facts in the four cases, and if you desire more detail, we could get you more detail on that.

Chairman GLENN. I would like to know how they did that, and where these refunds, illegitimate refunds were made, did we get that money back?

Ms. RICHARDSON. I do not know the answer to that, either, but we will find out and advise you for the record.

Chairman GLENN. There was some 200 cases. What was the total value of the refunds, do we know?

Ms. RICHARDSON. Rather than misstate it, I would like to furnish that for the record, if I could.

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The investigations accepted by U.S. Attorneys involved three employees who prepared 472 fraudulent tax returns and monitored refunds, totaling $430,017, using the REINF command code. These employees and nine individuals who conspired with these employees plead guilty to filing false returns. The IRS has either stopped or recovered $50,000 of the fraudulent refunds and the courts have ordered restitution of another $14,572. A fourth employee forged the signature of a taxpayer's estranged spouse on a tax return and refund check.

Chairman GLENN. If you would give us a rundown on that, we would appreciate it.

I want to follow up a little—I do not know whether Senator Roth got into this or not—but we have been into one code here that was sort of a general access more than the others, I guess.

The others are more specialized codes, I gather. Are we doing follow-ups in the other codes. You discovered the discrepancies here more by trend lines. A number of things in the codes that would not be accessed, generally where not so many people would be accessing these other more specialized codes, how do we protect in those? There might not be enough inquiry to make trend lines and they could still make changes in some of those returns. Is that an area that we have looked into yet? If not, how do we do it?

Mr. DOLAN. Senator, we did get just a little bit into it with Senator Roth, but what we explained was that we have done a similar type of review to the one we did in Southeast on that command code in several other regions and we promised to furnish some detail on what the outcome of those were.

Beyond that, though, also we are about to complete within the next couple of weeks a review of what we consider to be one of the more sensitive command codes, which is an adjustment capability. That is being done in the Atlanta, in the Southeast Region again, because of the experience and expertise they gained in the first one.

We have behind that, I believe, a total of several other very focused national reviews that we are doing based on the sensitivity command code, and essentially we are learning, Senator, from the sort of data distillation we did in the more generic command code, that it still amounts to a detection, a pattern detection capability. In most cases, there will be sufficient activity and sufficient ability to correlate one command code with another to develop that pattern.

The difficulty for us has been, up until the time frame when we did the Southeast study, all that data is locked in these reels of tape. The good news is we have an audit trail and the bad news is that audit trail on every one of those 100 million transactions a month fills up reel after reel, and there was no practical way to put in the hands of a manager any meaningful analysis.

We are now using the optical disk technology and we will install that over the next couple months in every region, not only for the inspection service to do it, but we are giving that capacity to line management, and we are expecting line management to run these pattern detection pieces of software to put in the hands of the day-to-day line managers some of these skills.

Chairman GLENN. I think you indicated on the phone to me yesterday, Ms. Richardson, that you will have new computers within 3 years or so. We will not have the complete system until 1996–97?

Ms. RICHARDSON. I think the complete system is closer to the year 2000, but we are actually bringing things on line and doing things now that are putting us in position.

Chairman GLENN. We have another vote and I am going to have to run again, and we are going to recess the hearing very shortly here.

Let me tell you, one of the things—and I think I indicated this on the phone to you yesterday—one of the things that has been a little vexing in trying to support IRS and get extra agents, which I did, and then they used some of them for administrative purposes, instead of what we thought we were getting them for back a couple of years ago. Another of the things that has been difficult has been the TSM system. We are going to have it in 6 to 8 years, and next year people come up and they testify again we are going to have it in 6 to 8 years.

I have been hearing 6 to 8 years now for about the last 3 or 4 years. What is the date that we are going to have this whole system on line and working? Do we have a good estimate on it now, and not a rolling target out here?

Ms. RICHARDSON. No, I do not think it is a rolling target, but it is kind of a rolling implementation. We are actually taking some steps and have some things now.

Chairman GLENN. I ask this, because we keep saying this new system is going to be great and it is going to help us solve all these things. When are we going to have the new system?

Mr. DOLAN. Just for example, that capability that I just talked about we will have in November.

Chairman GLENN. This November?

Mr. DOLAN. This November. I would not want to tell you that that is TSM, but it certainly is a downpayment on the path that we are trying to get to, and I think that is what the question is.

One of the things we look forward to, Senator, is being able to spend some more time with you and your staff, maybe in an October time frame, to——

Chairman GLENN. When you get these reviews done, can you give us a summary of those?

Mr. DOLAN. Certainly.[1]

Chairman GLENN. I am going to have to go now. I appreciate you being here this morning. It has been a long morning here and I think it has been a very interesting morning, though, and so we look forward to working with you on this. Obviously, we do not want to be coming back 7 years from now when you are still Commissioner, as you said earlier, and be going through some of these same things again. We want them corrected.

Ms. RICHARDSON. Thank you.

Chairman GLENN. The hearing will stand in recess until the call of the Chair.

[Recess.]

Chairman GLENN. The Committee will be in order.

Senator Dorgan just came back and he already voted and he had a couple of additional questions.

Senator DORGAN [presiding]. Commissioner, thank you for your indulgence. We had two back-to-back votes on a subject involving agriculture, which is of no small interest to North Dakota.

Ms. RICHARDSON. Also, we were joined by Ed Verburg, who is the Deputy CFO of the Treasury Department. I think he joined us after you left.

Senator DORGAN. I did have another couple of questions that I wanted to ask and then I will let you be on your way.

I do not mean to be sensational about the alarm about disclosure, access to records, and improper use of records, but it is the foundation of a voluntary system that people have some confidence that their sensitive financial information is not misused in any way.

[1] "Results of Internal Audits on IDRS and Other Computer Security Related Issues" appears in the Appendix on page 64.

When that is eroded or compromised, it is in my judgment extraordinarily serious.

I think I heard you say, and I wanted to be certain, that you are willing to and interested in initiating a systemwide evaluation of whether we have people browsing through financial records, whether we have adequate safeguards, whether information has been compromised. Is that correct?

Ms. RICHARDSON. That is correct. At an earlier break, I spoke with representatives of the GAO and they are more than willing to work with us to try to put together a comprehensive review at IRS.

Senator DORGAN. And you would initiate that expeditiously?

Ms. RICHARDSON. It will be under way this afternoon or tomorrow, I hope.

Senator DORGAN. I would think you, as a tax administrator, especially would want to know the results of that, because you cannot manage the system unless you know what the problems are.

Ms. RICHARDSON. Absolutely, and I feel very strongly that if there is anything that would undermine the credibility of the system, it would be a loss of confidence in the privacy and security of taxpayer information. And at a time when we are trying to improve compliance levels in our voluntary system, I do not think that we want anything out there that will somehow adversely impact on people's credibility in our system.

One thing, though, I would be remiss in not mentioning and emphasizing, a statement was made earlier today that perhaps we never admit that we make mistakes or do anything wrong. I do not think that is really correct and I think the record here today showed that we actually found these problems and brought them to light.

I think we are fairly introspective about a lot of things, and I think that is one of the strengths of the Internal Revenue Service. It is not easy and it is painful to have to admit the mistakes you make, but I think we are willing to do that and are willing to undertake this review and abide by what we find.

Senator DORGAN. Well, it is painful to admit mistakes. That is certainly true in politics, as my colleague will attest to. But it is also something most people want to avoid and most agencies want to avoid. You are not in a situation where, as the new Commissioner, you are going to come trucking up to Capitol Hill and say: Look what we have done wrong lately. You are very much going to probably find out what is going on that is wrong and fix it, but you sure are not going to want the Washington Post or Congress to find out. So I think that is why——

Ms. RICHARDSON. But in fairness to the agency, since it did not happen on my watch, I think they did bring this to the attention of GAO when the audit began. There was never any effort to hide any of this and it was made public.

Senator DORGAN. I understand the point. Let me ask Mr. Dolan or you, Commissioner, about the 300-some people who were identified in the Atlanta area as beaching confidentiality requirements. I understand the manner in which you described some of the indiscretions and some of the compromising of information. Some I assume is very serious and some represents fraud. Apparently a couple were referred for criminal prosecution, and others represent curiosity and browsing. Is that correct?

Mr. DOLAN. That is correct.

Senator DORGAN. Would you describe that once again for me? What represents that array of 300-some cases? Then I would like you to describe what procedures you have to deal with these employees?

Let us assume an employee says: I would like to know what kind of tax information is on record for a couple of Senators, some movie actors and actresses, a couple of business people in my State, and some neighbors. I would like to get access to them and talk to my friends a little bit. What do you have to deal with employees with? Can you fire or discharge employees for indiscretions?

Ms. RICHARDSON. Absolutely.

Senator DORGAN. If so, what kind? What was the disposition or what is the disposition of the 300-some people that were found in the Atlanta area to have compromised themselves with respect to this information?

Mr. DOLAN. Senator, what I had offered to do with Senator Roth and make it available to the Committee is give a more complete rendition of the actual follow-up of those cases. What I had mentioned to him was that when you break out the 154 cases for which some action was taken, they ranged on the high side from some resignations that occurred after people knew they were under investigation, of which there were three, and then there were three removals where we took action to remove the persons, 38 suspensions, 67 reprimands, and——

Senator DORGAN. Just stop there. For what would you suspend somebody?

Mr. DOLAN. I told Senator Roth that I would probably do a better job of getting you what we had prepared as a table of penalties, to sort of try to lay out the landscape, to insure that, from manager to manager, there was consistency in the way an offense was viewed. I would happily make that available to you as a better underpinning of how those cases were disposed of.[1]

But I think the question he raised, and maybe you are raising as well, is where we find actionable offense, are there any limits on our being able to move on it, and that really is not a problem. We have in the past, are in the present and will in the future, I think, have the tools available to us to take disciplinary or adverse action where it is called for.

Senator DORGAN. The reason I ask the question is this: If there were only three removals in this array of employees, who were involved in some actions that at least raised some serious questions of auditors here, does that suggest that maybe we are not dealing harshly with employees?

Mr. DOLAN. One inference could be that. Senator, the other inference would be that the nature of the offense—and this again we had a little discussion on before—the nature of the offense in many of these instances was something that the employees viewed as harmless. We came back and said, because your neighbor asked you to inquire about his refund, you may have thought it was

[1] "IDRS Security Violations" appears in the Appendix on page 62.

harmless, but that is not part of what you are expected to do and, in fact, you are prohibited from doing it.

Many of those kinds of instances would have made up the vast majority of the actionable areas. When you got to the other end of it, where you had some complicity with some outright fraud, those are the ones where there was summary removal.

I think maybe we would leave you to be the judge of this table of penalties and whether we reacted correctly, but I think it would be our view that we did react with penalties commensurate with the offense.

Senator DORGAN. In order for us to evaluate that, we would need the information that you apparently indicated you would provide us. Could you just give me some additional information about the 55,000 or so employees who have access to that information? If you were hiring one of those employees today, a new employee who is going to have access to that information, what will that employee be required to do in terms of signing employee agreements, reading and understanding confidentiality requirements and so on? Could you review that with us?

Mr. DOLAN. Certainly. First of all, we will put that employee through some form of a background check to check police records and try to make some credible veracity assessment before we bring him on roll. When we bring him on roll, the very first day that he is brought on board, he or she is given rules of conduct, focused specifically on the privacy and the security aspects of their job. They will find themselves in their first and second and every training course, particularly in the service center, having some emphasis on IDRS and its security.

Annually, there will be a refresher and review of the rules of conduct, and frequently the security and disclosure items will be identified in that. Over the last year, we have used our in-house publications using the Atlanta review to again highlight IDRS security, especially in these areas that employees might have thought they were gray areas or thought there was nothing wrong, if there is no gain or no malevolent intent, maybe it is OK to look. We have tried to reemphasize those areas that would have been the unwitting offenses perhaps in the past. So we think there is a fairly recurrent stream of reenforcement.

I think the other thing we might have mentioned when you were out of the room is something we did not have in the past, is we did not have as good a detection technology available to our on-site security officers. We are in the process of putting in place an optical disk capability that will be installed this coming November around the country that puts in the line managers' hands an ability not to have to go back to these voluminous audit trails, but to be able to do pattern recognition, to be able to do this kind of detection work. We feel pretty strongly that our study in Atlanta had very much of a deterrent effect on the rest of the country, because as the employee understands that we are looking for patterns, looking for these kinds of potential abuses, employees react to that the way we had hoped they would.

Senator DORGAN. Let me ask one additional question about the accounts receivable system. We have been aware now for some while that you don't even age accounts receivables. It surprised me, because that is pretty fundamental. It is a basic process to take a look at accounts receivable and age them and work it on that basis.

Are you making progress in that area? Second, can you tell me about something called the queue. I understand that you move accounts receivables into a queue that is a non-worked area if they are estimated not to be productive accounts receivables. Is this true?

Mr. DOLAN. I think probably, as a former tax administrator yourself, you know the queue is a despicable concept. That means that you are not going to get to that work. The queue, in fact, has been less for us a judgment that there is no collection potential and more a judgment that, given the particular deployment or resources in an area, that we will work the highest value.

You correctly point out that our system of classification of our work prioritization did not in the past make consider aging. Dollars, were too much of a governor, as opposed to the aging. I think we are making vast progress in dealing with accounts receivables in a more intelligent way.

But our queues today, Senator, would be less a judgment of no collection potential and more a judgment that in some parts of the country we just do not have the staff power to get to below a certain dollar threshold in collection.

Senator DORGAN. Are these queues by region?

Mr. DOLAN. Actually, they function by district, because they exist by district. Some districts may have absolutely no queue, other districts may have queues, and they change reasonably quickly. You can have an economic downturn in one part of the country and go from a queue that has virtually nothing in it, to a queue that is large and has some high-dollar values in it.

What we tried to do increasingly over the last couple of years is move as much of that work around as we can. Where it does not actually require a face-to-face meeting or we can do it by telephone or do it through service centers, we try to move it around and diminish the need to queue those things up in one part of the country.

Senator DORGAN. Do you know the aggregate amount of accounts receivable that is in the queue at this point?

Mr. DOLAN. I could furnish that to you. I do not know it.

Senator DORGAN. If you would do that.

Mr. DOLAN. Surely.

INSERT FOR THE RECORD

Delinquent accounts in the workload queue have received full notice and Automated Collection System processing. We have been unable to reach resolution with the taxpayer (for example through an installment agreement) and have exhausted all sources of enforced collection short of seizure and sale of tangible assets.

The account will reside in the queue until there are available revenue officer resources to work it. We will continue to offset overpayments from other periods. Additional amounts due (on this or other periods) will increase its priority for future assignment to active inventory. In addition, we send semiannual notices requesting payment.

As of July 1993, the queue inventory of accounts receivable was as follows:

Taxpayers—$576,668
Tax modules—$1,272,350
Amount due—$4,340,739,340

Senator DORGAN. Senator Pryor.

Senator PRYOR. Thank you, Senator Dorgan. Do you have further questions? I am in pretty good shape on time.

Senator DORGAN. Go right ahead.

Senator PRYOR. Thank you.

I was in the middle of a question to our new Commissioner here, and that was relative to the notification that might be given or might not be given by the IRS to any taxpayer who had had their confidentiality breached or their privacy breached. I am wondering if you have established a policy on that during the last 30 minutes.

Ms. RICHARDSON. No formal policies have been established in the last 30 minutes. I guess as I was starting to say, I think I would like to give a little more thought to it. I think my initial reaction is that some of it, maybe even the majority of the kinds of things that Mr. Dolan was talking about today, I am not sure, given the time frame it happened and the amount of effort it might involve in going back to try to ascertain which accounts were looked at and what was done, I am not sure there would be a serious value to that in terms of tax administration or enhancing the privacy or protecting the taxpayers' rights.

I guess I would like to give some thought to what we might do in the future. One of the things that I mentioned earlier is we are going to have a comprehensive review of this whole subject. And I think maybe one of the things I would like to do in connection with that is perhaps give some further thought to what would be appropriate when there has been a violation.

INSERT FOR THE RECORD

The recently completed IDRS privacy and security action plan assigns the Privacy Advocate the responsibility for considering and recommending under what circumstances, if any, taxpayers will be notified of inappropriate access to their account data. This action item is scheduled to be completed by December 1993.

Senator PRYOR. If I might, I want to respectfully put you and the agency on notice that I think there are going to be a lot of questions about this from this Senator. I am going to really come down hard on the fact that I think anyone that we can identify whose file has been browsed for no official reason, I think that taxpayer needs to know that and I am going to be asking you about that from time to time.

Ms. RICHARDSON. I am certainly not on a going-forward basis even disagreeing with you about that. I guess I question whether it makes sense to try to go back and reconstruct at this point.

Senator PRYOR. What brings this to our attention really is this: On October 23, 1992, a review of controls over IDRS security, which says "for official use only," now this report really just surfaced in the last couple of days. Did you know about the report before this? When did you know of this report?

Ms. RICHARDSON. I have been aware of it for some time and I think it has been widely known. GAO certainly knew about it, because we gave it to them in the course of their audit. I think perhaps you were away, but I mentioned this to Senator Glenn, that there certainly was no effort to hide it from anyone. I do not know when it was actually given to GAO. Do you recall?

Mr. DOLAN. Senator, I think it was part of the last annual IG report to the Congress. There was an identification of the work that was done in this area furnished by the Treasury Inspector General.

Ms. RICHARDSON. I think about 6 months ago that was furnished to Congress.

Senator PRYOR. This particular report was?

Ms. RICHARDSON. Yes.

Mr. DOLAN. I do not know whether the report was——

Ms. RICHARDSON. The information in it.

Senator PRYOR. I see some of your colleagues nodding affirmatively. I will take their word for it or take their nod for it.

Ms. RICHARDSON. They are not disagreeing with me.

Senator PRYOR. Now, I am going to ask a question on a little different area in just a moment. It does relate to this October 1992 report, the quote on page ii: "Ongoing integrity reviews in the North Atlantic and Western Regions also identified administrative cases similar to those in the Southeast." It seems like we have concentrated on your former region, Mr. Dolan. "Although their results are incomplete, employees are browsing taxpayer accounts for no clear business purpose."

Now, are the reports complete in the North Atlantic and Western Regions?

Mr. DOLAN. I believe they are, as well as the Midwest Region, and one of our discussions we had earlier, Senator, was a willingness to furnish those, as well as one that I may have referred to while you were out, where we have taken beyond the research code, an actual adjustment code and worked that in the Southeast Region, looking on a more sensitive basis what were the results, and we had agreed to furnish the Committee the results of those.[1]

Senator PRYOR. I thank you for that. I just have three more questions.

In 1989, then Commissioner Goldberg instituted a hotline. This hotline is described in a memorandum to all employees of IRS, went out October 24, 1989, from Mr. Goldberg, the Commissioner. He says here is a new hotline and we urge all of you to report allegations of any misconduct. What is the status of the IRS hotline? Is it still being used by employees? And what activities do you hear about? Have you heard anything like this that has been reported by any other employees?

Ms. RICHARDSON. We certainly still have the hotline and it is being used. I do not know whether any of these situations have been reported.

Senator PRYOR. By the way, who answers the hotline?

Mr. DOLAN. Actually, there are a couple of people.

Senator PRYOR. You do not answer, do you, Mr. Dolan?

Mr. DOLAN. No, sir, I do not. There are two hotlines. There is one that comes into our Inspection Service and another that goes to the Inspector General. I think we could probably get you a pretty good synopsis of the kind of calls that are coming in. I do not know per-

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[1] "Results of Internal Audits on IDRS and Other Computer Security Related Issues" appears in the Appendix on page 64.

sonally whether this area of IDRS security would have been a subject——

Senator PRYOR. I think that would not only be helpful for us on this Committee and also on the Finance Committee, but I think it would certainly be constructive if you knew what kind of complaints were coming in, because evidently this story that has broken is going to raise a lot of concerns out there in the public and I am sure with the employees who are trying to do a good job with the IRS.

Ms. RICHARDSON. We have a sense of the types of calls. I do not know and I do not think Mike knows whether or not the specific concern about IDRS security was raised on a hotline call.[1]

INSERT FOR THE RECORD

Since its inception in 1989, the Inspection Service Hotline has received 32 allegations related to the improper use of the IDRS. Of these 32 allegations, six were sent to the Inspector General at the Department of Treasury for investigation, 13 were investigated by Internal Security, three were referred to management for appropriate action, seven did not merit further action, and three are pending investigative determination.

Senator PRYOR. I think we are about to have another vote. I just ran into Senator Glenn in the hall, Senator Dorgan, and he told the two of us when we finish our questions to adjourn the meeting. I have completed at this time.

I want to thank our witnesses. We look forward to working with you. You have a big responsibility.

Thank you.

Ms. RICHARDSON. Thank you.

Senator PRYOR. I yield my time.

Senator DORGAN. Thank you, Senator Pryor.

Let me ask one additional question as we go. It is about this notion of counseling. When I asked the questions earlier about counseling employees, my assumption was that counseling was provided to some employees who used the system because a neighbor wanted to know the status of the refund. Your counseling, I assume, explained to the employee that conduct is improper, that they may view it as innocent, but that is not proper to do.

I understand that answer, but because so few are discharged at least with respect to the 350-some cases, I am wondering on a broader scale, if we are dealing appropriately enough with these problems. When is counseling used, if ever, as a substitute for discharge?

Ms. RICHARDSON. I can answer from my own standpoint and certainly from the Service that counseling is for a certain level offense. And I can assure you that if discharge is appropriate, counseling is not the alternative, and that is not how counseling has been used.

I think Mr. Dolan has a list of the types of actions taken. I guess you did not get as far as counseling. There were 17 of that group who were counseled, and the counseling really related, I think, to situations where it was not entirely clear what—there was an indication that someone may have been in a record, but it was not

[1] Also see "Results of Internal Audits on IDRS and Other Computer Security Related Issues" in the Appendix on page 64.

clear when or why or what they had been doing and whether it was unauthorized, and they were given a warning and reminded of what the rules were. Where we ascertained that people did in fact violate the rules, they were disciplined or removed.

Senator DORGAN. One final question: Your answer to Senator Pryor a moment ago, when he asked whether the review has been completed in the Western Region and so on, is that you would provide him that information. If it has been completed, do you know what the results are and could you share those results with us?

Mr. DOLAN. I think we can do it most comprehensively by furnishing it to you, but in summary—and we had gotten into this a little bit with Senator Roth—the incidents in actual numbers are fewer in those three regions. We do not have hard scientific evidence, but we think there was, in fact, a deterrent effect that occurred from the organization's knowledge of what had happened in Southeast. We think the fact that we embedded it in the middle of the ethics training that was still being delivered around the country we think had something to do with it. The fact that we wrote about it in all of our in-house publications we think might have had some effect.

But I think for us, the real significant issue will be these series of ongoing reviews where we systematically look across the command codes to make sure that we do not have patterns there that are as problematic.

Senator DORGAN. So we will expect to receive from you a characterization of the 300-some instances, what we discovered happened, what the resolution was, and so on, is that correct? [1]

Mr. DOLAN. That is correct.

Ms. RICHARDSON. Yes.

Senator DORGAN. Thank you very much for your cooperation.

This hearing is adjourned.

[Whereupon, at 12:38 p.m., the Committee was adjourned.]

[1] "Results of Internal Audits on IDRS and Other Computer Security Related Issues" appears in the Appendix on page 64.

APPENDIX

PREPARED STATEMENT OF SENATOR COHEN

Mr. Chairman, I am pleased that you have called this hearing to address financial management issues at both the Internal Revenue Service and the Customs Service.

Today, the Committee will hear that shoddy bookkeeping at the Internal Revenue Service has resulted in tens of billions of tax dollars going uncollected. At Customs, sloppy, inaccurate inventories for both government-owned and seized assets have resulted in the "loss" or "misplacement" of guns, currency and large quantities of illegal drugs. Poor internal controls at IRS permitted rank and file employees to examine taxpayer files (including those of celebrities) for nonbusiness purposes. Reportedly, some employees manipulated the computer files of friends, family and others to obtain unauthorized, inappropriate refunds.

Furthermore, while requiring taxpayers to keep excruciatingly detailed financial records, the IRS fails to keep its own records in order. For example, GAO has found that the IRS inventory of computer equipment, claimed to be about $282 million, failed to account for additional equipment valued at $84.2 million. I find this especially disturbing because the IRS is asking Congress to spend $9 billion to modernize its computer system over the next few years. What assurances do we have that they will maintain control over new equipment if they cannot keep track of what they already have in-house?

Taxpayers do not understand why, in this age of cutting edge technology, the IRS uses antiquated computer systems which any self-respecting business would have replaced long ago. Reliance on these clumsy computer systems and grossly inadequate financial controls has resulted in billions of tax dollars going uncollected every year. The exact figure which goes uncollected is unknown. Just last year, IRS testified that approximately $110 billion in taxes remained uncollected. However, according to the GAO, this figure was wildly overstated due to accounting and system deficiencies which allowed for "duplicate and insufficiently supported assessments." At GAO's prodding, IRS now reports a much smaller figure, estimating that collectible, unpaid taxes total $21.6 billion, but GAO has not yet confirmed this amount.

Albert Einstein said, "The hardest thing in the world to understand is the income tax." Americans' understanding of their tax system, and their willingness to voluntarily report and pay the taxes they owe is not enhanced when they hear horror stories like these. Mr. Chairman, it doesn't take a genius of Einstein's intellectual abilities to recognize the gravity of this situation. The IRS must ensure not only that it administers the tax laws fairly, but also that it remains accountable to the taxpayers.

Financial management problems like those we are examining today affect more than just "bean counter" totals. Reports about missing guns or 1,800 pound discrepancies in marijuana inventories seriously undermine our government's credibility, because they underline our failure to safeguard taxpayer assets. Whether you are running a small business or the Federal Government, it is imperative that you have the mechanisms in place to keep track of your inventory. Failure to ensure accountability results in a loss of investor, and in this case, taxpayer confidence.

Mr. Chairman, as you know, the Governmental Affairs Committee has devoted significant time and attention to financial management issues over the last few years. Most recently we reviewed financial management problems at the Department of Defense, and we heard testimony describing a similar litany of inadequate controls, nonexistent reporting mechanisms, and outright fraud which resulted in the loss or waste of billions of taxpayer dollars. So revelations of waste and mismanagement at both IRS and Customs should come as no surprise to me or my fellow Committee members. We clearly have a lot more work to do if we want to put the government's financial house in order.

I look forward to hearing from our witnesses today. I hope their testimony will confirm that they understand not only what the problems are, but why it is so important to correct these problems.

UNITED STATES SENATE
COMMITTEE ON GOVERNMENTAL AFFAIRS
August 3, 1993

Hon. MARGARET M. RICHARDSON
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC.

DEAR COMMISSIONER RICHARDSON:

I am writing to express my concern regarding recent investigations into possible unauthorized access by IRS employees into computer systems containing Americans' sensitive tax information.

Recent investigations by your office of internal audit have revealed potential widespread abuses in which IRS employees across the country have browsed through tax records of friends, relatives, neighbors and celebrities. Moreover, a smaller number of IRS employees may have committed criminal offenses by using unauthorized access to manipulate tax information for personal gain.

I am troubled that the IRS knew about an increasing security risk to its computer system for several years, yet still paid little attention to the internal controls and security procedures that could prevent the abuses now being investigated.

What concerns me more, however, are indications that aggressive investigations of this matter have not been undertaken in all IRS regions. I am pleased that internal auditors conducted a comprehensive investigation of potential abuses in the Southeast Region, but this apparently has not been the case in other parts of the country. More limited investigations examining only individual IRS offices, and limited time frames, clearly will prevent the agency from determining the extent of wrong-doing in these cases. Additionally, the IRS has investigated abuses associated mainly with the computer code REINF, a general use code available to many thousands of employees. Almost no work has been done by the agency to ascertain the risk of fraud and abuse associated with unauthorized access of the other 55 computer codes commonly used on the Integrated Data Retrieval System (IDRS). Many of these codes, available to subsets of users, are more sophisticated then the REINF code. Consequently, their misuse by IRS employees, though harder to detect, potentially represents an even more serious risk to the tax system's integrity.

The Internal Revenue Service cannot permit any perception to exist that employees who may have breached Americans' trust in the confidentiality of their tax information will go undetected and, if guilty, unpunished. I remain concerned that the limited-scope investigations now underway will not discover the extent of violations by IRS employees, and will send an inappropriate message that undetected violations will be tolerated.

Commissioner Richardson, I urge your personal attention to this matter to ensure that comprehensive investigations are undertaken and that all potential violations are vigorously pursued. I am also requesting that the Inspector General for the Department of the Treasury monitor and, if necessary, assist in these investigations. Additionally, I have included for your information an attachment detailing the specific conclusions made by your internal audit group and Committee staff.

Finally, I request that you update my Committee staff on a regular basis on the progress of your investigations. Please have your staff contact Mark Goldstein of the Governmental Affairs Committee staff at 224–4751 with any questions on this matter.

Sincerely,

JOHN GLENN
Chairman

Attachment

FACT SHEET

UNAUTHORIZED COMPUTER ACCESS BY IRS EMPLOYEES

- A recent IRS internal audit report revealed 369 IRS employees in one region have been investigated for using unauthorized access to taxpayer data for non-business purposes.

- Preliminary investigations nationwide have already discovered an additional 100 individuals who are being investigated for unauthorized access to taxpayer data for non-business purposes.
- Of the 369 employees in one region, 5 are currently pending prosecution for preparing fraudulent returns, another 80 individuals are being investigated for potential criminal prosecution and about 154 have so far been subjects of disciplinary action.
- Nationwide, IRS has approximately 115,000 employees with approximately 56,000 who have access to the computer system for accessing and adjusting taxpayer accounts.
- None of the abuses were detected by IRS' security officials as part of their work.
- Only limited investigations have been done in the other regions on the one access code, REINF.
- There are 55 other access codes for accessing and adjusting taxpayer accounts. Investigations of possible abuses of these other access codes appear to have been limited or non-existent.
- Disciplinary actions taken against employees have been inconsistent and many investigations were pursued by IRS supervisors instead of trained investigators or auditors.
- IRS has known for years that its computer system for accessing and adjusting taxpayer accounts was at increasing risk for fraud and abuse.

UNITED STATES SENATE
COMMITTEE ON GOVERNMENTAL AFFAIRS
August 3, 1993

ROBERT P. CESCA
Deputy Inspector General
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC.

Dear MR. CESCA:

I am writing to express my concern regarding recent investigations into possible unauthorized access by IRS employees into computer systems containing Americans' sensitive tax information.

Recent investigations by the IRS' office of internal audit have revealed potential widespread abuses in which IRS employees across the country have browsed through tax records of friends, relatives, neighbors and celebrities. Moreover, a smaller number of IRS employees may have committed criminal offenses by using unauthorized access to manipulate tax information for personal gain.

I am troubled by indications that aggressive investigations of this matter have not been undertaken in all IRS regions. I am pleased that internal auditors conducted a comprehensive investigation of potential abuses in the Southeast Region, but this apparently has not been the case in other parts of the country. More limited investigations examining only individual IRS offices, and limited time frames, clearly will prevent the agency from determining the extent of wrong-doing in these cases. Additionally, the IRS has investigated abuses associated mainly with the computer code REINF, a general use code available to many thousands of employees. Almost no work has been done by the agency to ascertain the risk of fraud and abuse associated with unauthorized access of the other 55 computer codes commonly used on the Integrated Data Retrieval System (IDRS). Many of these codes, available to subsets of users, are more sophisticated then the REINF code. Consequently, their misuse by IRS employees, though harder to detect, potentially represents an even more serious risk to the tax system's integrity.

The Internal Revenue Service and the Department of the Treasury cannot permit any perception to exist that employees who may have breached Americans' trust in the confidentiality of their tax information will go undetected and, if guilty, unpunished. I remain concerned that the limited-scope investigations now underway will not discover the extent of violations by IRS employees, and will send an inappropriate message that undetected violations will be tolerated.

Mr. Cesca, I urge your personal attention to this matter to ensure that comprehensive investigations are undertaken and that all potential violations are vigorously pursued. I request that the Treasury Department Office of Inspector General monitor and, if necessary, assist the IRS internal audit group's investigation, and that you report to the Committee with your findings.

For your information, I have enclosed a copy of my letter to IRS Commissioner Richardson regarding this issue. Please have your staff contact Mark Goldstein of the Governmental Affairs Committee staff at 224–4751 with any questions on this matter.

Sincerely,

JOHN GLENN
Chairman

Attachment

FACT SHEET

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- There are 55 other access codes for accessing and adjusting taxpayer accounts. Investigations of possible abuses of these other access codes appear to have been limited or non-existent.
- Disciplinary actions taken against employees have been inconsistent and many investigations were pursued by IRS supervisors instead of trained investigators or auditors.
- IRS has known for years that its computer system for accessing and adjusting taxpayer accounts was at increasing risk for fraud and abuse.

August 4, 1993

The Hon. John Glenn,
Chairman,
Senate Committee on Governmental Affairs,
340 Dirksen Building,
Washington, DC.

DEAR MR. CHAIRMAN:

This is in response to your August 3, 1993 letter expressing concern regarding reports of unauthorized access by some Internal Revenue Service employees into IRS computer systems. As we discussed yesterday, I, too, am deeply concerned by the reports of our Chief Inspector indicating that some IRS employees have improperly accessed taxpayer accounts. As I noted to you, the IRS has already taken a number of steps to detect, preclude, or punish any unauthorized access. However, I plan to personally ensure that the IRS implements all actions necessary to strengthen internal controls and computer security procedures to prevent unauthorized access. As Commissioner, I will not tolerate any abuse of the trust the American taxpayers have placed in us.

To give this issue some context, the IRS has long recognized the potential for employees to improperly access taxpayer accounts and instituted procedures to protect against such improper access. In 1991 the Inspection Service initiated an audit by the Southeast Region to evaluate the effectiveness of these procedures. Since that time, nine additional reviews have been conducted in the other six regions. The reviews have focused on multiple accesses to the same accounts using various time periods and review criteria. In three regions all employees who used a particular command code were screened for potential abuse.

Building on the experience gained from these projects, the Inspection Service has identified inherently high-risk operations for further review, such as credit transfers and adjustments to taxpayers' accounts. Each region is developing review techniques and computer analyses in an assigned high-risk area; if employee misconduct is detected in that area, these techniques will be implemented nationally. Because these reviews will involve multiple computer file matches governed by the Computer

Matching and Privacy Protection Act of 1988, we are taking steps to satisfy its requirements. We expect that these requirements will be met by October 1, 1993.

We will also use new technology to improve the monitoring of employee access to taxpayer accounts. This technology will bring some of the techniques used in the intensive Inspection reviews to line managers who have the primary responsibility to prevent and detect abuses by their employees. The IRS is currently piloting this technology in the Southeast Region, and it will be available in the remaining regions by early 1994. In addition, Tax Systems Modernization will provide new capabilities to further control access to taxpayers' accounts. Even with these additional safeguards, we will continue to require managers to control access and we will continue to rely on Internal Audit to provide independent and objective reviews of these security programs.

We have taken a number of actions to enhance employee awareness of their responsibilities to safeguard taxpayer information. All employees having access to automated taxpayer account systems must sign a statement that they have received and understand the security rules and that violations of these rules could result in disciplinary action. We have instituted procedures to ensure that managers review all potential violations and apply appropriate, consistent penalties. In addition, we have highlighted these issues in our Ethics training and in employee newsletters.

Mr. Chairman, I welcome your oversight of our efforts in this area. I have enclosed additional points to clarify the Fact Sheet attached to your letter. We will work with your staff and the Treasury Inspector General to ensure you and the American people that we will take all necessary steps to protect the confidentiality of their tax return information.

Please do not hesitate to call me if you have any additional questions.

Sincerely,

MARGARET MILNER RICHARDSON

Enclosure

August 4, 1993

FACT SHEET

UNAUTHORIZED COMPUTER ACCESS BY IRS EMPLOYEES

- A recent IRS internal audit report revealed 369 IRS employees in one region have been investigated for using unauthorized access to taxpayer data for non-business purposes.
- Preliminary investigations nationwide have already discovered an additional 100 individuals who are being investigated for unauthorized access to taxpayer data for non-business purposes.
- Of the 369 IRS employees in one region, four employees are currently pending prosecution for preparing fraudulent returns, another two employees are being investigated for potential criminal prosecution and so far 154 have been disciplined: fired, suspended, reprimanded or counseled.
- Nationwide, IRS has approximately 115,000 employees with approximately 56,000 who have access to the computer system for accessing and adjusting taxpayer accounts.
- None of these abuses were detected by IRS' security officials as part of their work.
- The Inspection Service conducted nine reviews of the use of a computer command code called "REINF" in the other six regions. Four of these reviews are still open and being actively pursued. Based on one region's research efforts, the other regions used various time periods and screening criteria to conduct significant detection work.
- There are numerous other access codes for accessing and adjusting taxpayer accounts. Investigations of possible abuses of these other access codes appear to have been limited.
- Although the audit report identified inconsistent disciplinary actions as a national issue, procedures were issued in the Southeast Region to ensure consistent management action on the 369 employee cases. Based on the facts gathered by Internal Audit, a determination was made to refer criminal or serious misconduct cases to Internal Security for investigation. The remaining cases were referred to management for resolution and appropriate action.
- IRS has known for years that its computer system for accessing and adjusting taxpayer accounts was at increasing risk for fraud and abuse.

26. IDRS SECURITY VIOLATIONS	
a. Unauthorized updating or causing an unauthorized updating of accounts.	14-day Susp. --Removal
b. Unauthorized accessing or causing an unauthorized accessing of one's own account.	Admonishment --Reprimand
c. Unauthorized accessing or causing an unauthorized accessing of another's account.	Reprimand-- Suspension
[Key penalty factors for 26b and 26c: number of accesses, sensitivity of information, reasons for accessing.]	
27. OTHER OFFENSES — GENERAL	
a. Offenses having a substantial adverse impact on the employee's ability to perform and the accomplishment of the mission of the agency because of the seriousness of the misconduct, the loss of trust or confidence in the ability of the employee to perform duties successfully, and/or significant actual or potential impact on the agency.	14-day Susp. --Removal
b. Offenses having a moderate impact on the employee's ability to perform and the accomplishment of the mission of the agency.	Reprimand-- Suspension
c. Offenses having a minor impact on the employee's ability to perform and the accomplishment of the mission of the agency.	Admonishment --Reprimand
[Key penalty factors for 27a, 27b, and 27c: nature and seriousness of offense, relationship to employee's duties, position of employee, and notoriety.	

DRAFT

New Exhibit 0751-6 Guide for Penalty Determinations

This Guide presents various types of misconduct and a penalty or range of penalties that would normally be expected to correct a first offense.

This Guide is not intended to be an exhaustive listing of all offenses. In the absence of more specific guidance, item number 27 may be utilized for penalty determinations in matters not otherwise covered. "Key penalty factors" are indicated for several offenses, especially those with a broad range of actions. These are factors most likely to be significant in determining a penalty for those offenses. **However, in deciding on a corrective action, all relevant factors, including those listed in IRM 0752.43(12)(4)(c), i.e., the "Douglas" factors, and the supplemental guidance in IRM 0751.16 dealing with the accountability of various positions, are to be considered.**

The listing of penalties or ranges of penalties is not intended to imply that a greater or lesser penalty is inappropriate if, in the assessment of management, predominant aggravating or mitigating circumstances are present which require a greater or lesser penalty.

- o A corrective action which is below the range indicated could be appropriate for minor or technical violations, or cases in which there are compelling mitigating factors.

- o A corrective action which is above the range could be appropriate for particularly egregious misconduct, or cases in which there are significant aggravating factors. Even for offenses where removal is not listed, removal for a first offense is not precluded.

- o Multiple offenses or offenses which violate more than one law, rule, regulation or practice, normally will be grounds for more severe action than indicated for a single offense.

- o Repeated offenses, whether or not they are of the same kind or directly related, normally will be grounds for more severe action than indicated, including removal.

The guide does not apply to employees serving a probationary or trial period. Failure to demonstrate fitness for continued employment will result in a termination during the probationary or trial period (see IRM 0315.1).

Demotions may be effected when appropriate, e.g., in lieu of removal, when the offense would not reasonably impair successful performance in another position (if available).

RESULTS OF INTERNAL AUDITS ON IDRS AND
OTHER COMPUTER SECURITY RELATED ISSUES
(In response to questions posed by
Sentors Glenn, Roth, Pryor, and Dorgan)

Scope of Inspection Service Activities Related To Computer Security

From October 1, 1990 to July 31, 1993, 45 of 305 (15%) final Internal Audit reports identified computer security and privacy concerns with both existing or future computer systems. These reports covered existing systems such as IDRS, the Electronic Filing System and the payroll/personnel system. System development reports covered future systems such as the Document Processing System, the On-Line Entity Project, and the Midwest Region Automated Compliance System (MACS).

During this same period, auditors and investigators conducted 34 integrity projects that were designed to detect indicators of computer fraud or misuse of sensitive taxpayer information sufficient to warrant investigation. Of the 34 projects, 17 dealt with employee's use of the IDRS command code REINF. (Auditors completed one other project that reviewed the REINF command code prior to October 1, 1990).

From October 1, 1991 to July 31, 1993, 377 of 3,391 (11%) investigations completed by Internal Security investigators related to the improper use of sensitive taxpayer information processed by IDRS. Investigators substantiated the improper use in 231 investigations. Sources external to the Inspection Service provided information to originate 61% of the 231 investigations. These sources included IRS employees, taxpayers, and anonymous sources. Inspection Service initiatives, such as our Integrity Projects, were the source of the remaining 39% of the 231 investigations.

Since its inception in 1989, the Inspection Service Hotline has received 32 allegations related to the improper use of the IDRS. Of these 32 allegations, six were sent to the Inspector General at the Department of Treasury for investigation, 13 were investigated by Internal Security, three were referred to management for appropriate action, seven did not merit further action, and three are pending investigative determination.

In addition to our customary audit and investigative efforts, Inspection Service personnel participated on various oversight groups, such as the Privacy and Security Council and Information Systems Control Groups. We also assisted management in their efforts to improve computer security by performing security penetration tests at two computer facilities and participating on task forces that assessed IRS computer security and privacy policies and business practices.

Summary of REINF Projects

Since October 1989, the Inspection Service has conducted 18 Integrity Projects that involved tests of the IDRS command code REINF. As of July 31, 1993, 13 projects have been completed and five projects were in process. Inspection Service personnel have expended approximately 30 staff years on these projects.

One project began on October 24, 1989 when auditors in the Southwest Region initiated a limited review in the Austin Service Center to determine if employees were using IDRS to manipulate taxpayer accounts and generate manual refunds. The auditors used computer audit techniques to analyze audit trail information for an 11 month period. They identified over 63,000 IDRS transactions for possible review and applied various criteria to this universe to select 1,800 transactions for manual review.

Prior to the Southwest Region project, Inspection Service personnel in the Southeast Region originated a research and development effort that used optical disc technology to store and analyze the massive volumes of IDRS audit trail information. This new computer tool was used in four integrity projects related to command code REINF, the first of which began in May 1990. Auditors used computer analyses in these four projects to search for indicators of improper use of the command code REINF by IRS employees of the Southeast Region.

In October 1990, the Assistant Chief Inspector (Internal Audit) issued a nationwide alert which highlighted the Southeast Region's methodology and results. Subsequently, the other six Inspection Service offices initiated 13 Integrity Projects related to the use of the REINF command code. In nine of these projects, auditors conducted computer analyses that covered multiple filing seasons and included all employees authorized to use the REINF command code in the office's reviewed. The four other projects focused on more limited situations, such as known integrity breaches or more precise populations of employees.

The 18 projects reviewed the use of the REINF command code by approximately 24,000 employees in nine of 10 service centers and 45 of 63 district offices. As of July 31, 1993, auditors had referred 168 instances of questionable use to Internal Security for investigative determinations and 290 instances to management for appropriate action. All but one of the 290 referrals to management were in the Southeast Region.

Internal Security investigators initiated 106 investigations on the 168 referrals received from auditors. Internal Security sent 24 of the remaining audit referrals to management for appropriate action after determining that the questioned use did not warrant investigation, closed 30 referrals with no action, and has eight pending investigative determination.

Of the 106 investigations initiated by Internal Security, investigators referred 22 cases to U.S. Attorneys for prosecutive determination. Ten of these 22 investigations involved one employee and nine other individuals who were identified as part of one of the 106 original investigations. U.S. Attorneys accepted 13 of these investigations for prosecution and declined prosecution of seven investigations. The two remaining referrals are pending prosecutive determinations.

The investigations accepted by U.S. Attorneys involved three employees who prepared 472 fraudulent tax returns and monitored refunds, totaling $430,017, using the REINF command code. These employees and nine individuals who conspired with these employees plead guilty to filing false returns. The IRS has either stopped or recovered $50,000 of the fraudulent refunds and the courts have ordered restitution of another $14,572. A fourth employee forged the signature of a taxpayer's estranged spouse on a tax return and refund check.

As of July 31, 1993, management resolved 382 of 397 questionable instances referred by auditors and investigators. Management actions are pending in 15 instances. Employees received the following disciplinary actions:

- 11 employees resigned;
- 5 employees were removed;
- 63 employees were suspended or demoted;
- 93 employees were reprimanded or admonished; and,
- 20 employees were counseled or given caution letters.

In addition, 12 employees retired, resigned or died before administrative actions could be taken, two employees were removed for separate offenses, and one situation was returned to Internal Security for investigation. Management determined that 175 questionable accesses were authorized or could not be substantiated. Of these 175 instances, 171 occurred in the Southeast Region.

Prepared Statement of Mr. Bowsher

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss the results of our recently completed financial statement audits at the Internal Revenue Service (IRS) and the Customs Service and the need to accelerate government-wide financial management reform through the full and effective implementation of the Chief Financial Officers (CFO) Act of 1990.

Our financial audits at IRS and Customs show that serious financial management problems exist at the Department of the Treasury. The results of these audits and our work at the Department of Defense, on which I testified before you on July 1, 1993,[1] demonstrate the necessity of preparing and auditing annual financial statements.

The CFO Act's pilot program of agency-level audited financial statements has proven that this process pinpoints problems and provides the road map needed to establish financial accountability and control. The audits are demonstrating that there are specific flaws in budget execution needing correction, that particular steps should be taken to improve the efficiency and effectiveness of government, and that better accountability measures will protect against unnecessary losses. It is my hope that the requirement for audited financial statements will be expanded to all major agencies and departments and implementation of the CFO Act will be strengthened. We also believe that the time has come to arrange for audited government-wide financial reports that will tell the American public where its government stands financially.

Through the CFO Act's pilot financial statement audits, IRS and Customs management have begun the process of improving their financial reporting and the quality of the underlying financial and program performance data. Also, they have gained a greater insight into the areas needing improvement and are now better able to focus on solutions to fundamental problems for which a number of corrective actions are already underway. Further, the Congress has a better idea of how these organizations are actually functioning. Among the results of these financial audits are the following.

—The Congress now has reliable estimates of IRS' receivables and the related collectible amount, which are tens of billions of dollars less than what had been reported by the agency in the past. Also, management efforts of the IRS to address the collection function can now be better focused.

—Revenue information at IRS and Customs, covering over 99 percent of the government's total revenues, has undergone an audit for the first time, highlighting for management's attention a wide range of problems with the quality of the information and with fundamental internal controls over billions of dollars. For instance, IRS will need to overcome a problem whereby its systems cannot provide details as to amounts of specific excise taxes collected. As a result, general tax revenues inappropriately subsidized excise tax trust funds, perhaps by billions of dollars. This condition has important management implications and may have some effect on excise tax policy.

—IRS is presently focusing on fixes to problems involving unauthorized access to taxpayer information and serious weaknesses regarding the use of its appropriated operating funds that have led to (1) unreconciled differences between its records and Treasury's cash records, (2) unresolved discrepancies and transactions in suspense accounts, and (3) duplicate and other inappropriate payments to contractors.

—At Customs we noted many opportunities for seized drugs, weapons, and currency to be stolen or misappropriated without detection. The audit has provided additional impetus to address serious control weaknesses evident throughout the seized property process, from the time property is seized until disposed of, that could result in financial loss to the government or danger to the general public.

—Information has been provided to Customs management and the Congress about the great reliance Customs places on importers and brokers to voluntarily assess and honestly report the amount of duties, taxes, and fees owed on imported merchandise. Customs and the Congress can now better address the potential for additional revenue through an increase in the level of inspection and monitoring.

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[1] *Financial Management: DOD Has Not Responded Effectively to Serious, Long-standing Problems* (GAO/T-AIMD-93-1).

Other civilian agencies, including those participating in the CFO Act's pilot program, likewise have received important benefits from the audited financial statement process. For the Committee's benefit, I have attached to my testimony a summary of the results of financial statement audits of (1) the student loan program at the Department of Education and (2) the Social Security Administration (SSA). (See attachment I.) Some examples follow:

—Insights into the costs and operating problems of Education's guaranteed student loan program were disclosed by our recently completed financial audit and are being considered in pending legislation. The Department's use of overly optimistic projections of loan defaults has contributed to a nearly $3 billion shortfall in Education's budgetary estimates of program costs for fiscal years 1992 and 1993. There is now additional emphasis to address misplaced incentives and conflicts of interest that are built into the present student loan program.
—Six years ago, SSA, much like IRS and Customs this year, began the challenge of preparing financial statements that could withstand audit scrutiny. Through a sustained effort, this year the audited financial statements were available in February 1993—in time to be useful for appropriation hearings and budget deliberations—and included extensive performance information tied to many of SSA's strategic goals and objectives.

In my July 1st testimony, I spoke to you about the need for leadership at the Secretary of Defense level to address longstanding financial management weaknesses. The problems we identified at IRS and Customs, coupled with our findings at Defense, demonstrate not only the need for agency leadership but also for strong leadership at the Presidential, Office of Management and Budget (OMB), and Treasury levels. Government-wide implementation of the CFO Act must be greatly accelerated and made a top priority of the administration. While important progress has been made in the 2½ years since the passage of the act to set a foundation for change and to better identify problems, a greater sense of urgency is needed to solve a range of problems that pervade government.

Decisive action is needed now to reform federal financial management by:

—selecting an OMB Controller with proper credentials as a financial management leader and a team of highly qualified agency CFOs who can work together to solve difficult common problems;
—drastically overhauling existing processes, controls, and systems and, in the interim while new systems are being developed, increasing discipline over basic accounting functions such as transaction processing and reconciliations;
—attracting and retaining qualified financial management personnel;
—expeditiously developing generally accepted accounting, financial reporting, cost, and systems standards to guide the agencies' improvement efforts; and
—fostering a strong program of financial statement preparation and auditing.

Our financial audits at IRS and Customs represent the first such audits of these organizations, requiring a major effort by these agencies. Before discussing our specific audit findings, I would like to recognize both agencies for their cooperation and strong efforts to implement the CFO Act. In contrast to the concerns I raised to the Committee on July 1st regarding the Department of Defense's response to its serious financial management weaknesses, both IRS and Customs management have been very responsive to our audit findings and have made progress toward developing reliable information and establishing financial control.

Nevertheless, we were unable to express an opinion on the reliability of IRS' and Customs' fiscal year 1992 financial statements because critical supporting information for billions of dollars was either not available or was unreliable. Preparation of financial statements presented a substantial challenge to IRS and Customs. This undertaking was made especially difficult because their existing systems were not designed to provide meaningful and reliable financial information needed to effectively manage and report on their operations. Compounding this problem, internal controls were not designed and implemented to effectively safeguard assets, provide a reasonable basis for determining material compliance with certain laws and regulations, and assure that there were no material misstatements in the financial statements.

IRS and Customs have begun the process of rebuilding their financial management processes and systems. Continued strong implementation of the CFO Act by these agencies can result in a tremendous payoff through an improved ability to safeguard assets, manage operations, and collect revenues. But the job will not be easy. Using audited financial statements as an important foundation to improve financial management, IRS and Customs will have to overcome the broad range of very serious problems that our financial audits have identified. This will require sustained, high priority management attention and congressional support.

I will now highlight the results of our IRS and Customs audits.

SERIOUS WEAKNESSES EXIST IN IRS' FINANCIAL MANAGEMENT OPERATIONS AND CONTROLS, AND MANAGEMENT IS ACTING TO ADDRESS THESE PROBLEMS

First, I would like to discuss some of the more severe problems we identified in our audit of IRS' financial statements.[2]

IRS Significantly Overstated Its Accounts Receivable

After performing a detailed analysis of IRS' receivables as of June 30, 1991, we estimated that only $65 billion of about $105 billion in gross reported receivables that we reviewed were valid and that only $19 billion of the valid receivables were collectible. At the time, IRS had reported that $66 billion of the $105 billion was collectible.

Historically, IRS reports have significantly overstated its receivables primarily because IRS included duplicate and insufficiently supported assessments that it had recorded as part of efforts to identify and collect taxes due. While IRS may have a need to maintain such records for enforcement purposes, these and many erroneous assessments were not valid receivables for financial reporting purposes and should not have been included in the reported balances. In addition, IRS' estimates of the collectibility of its receivables have been unreliable because, in addition to including invalid receivables, IRS relied solely on collection experience and did not group assessments according to their collection risk or consider the taxpayer's current ability to pay. This unreliable information on IRS' accounts receivable has affected decisions about the (l) impact of increased collections on the deficit, (2) evaluation of enforcement and collection performance, (3) determination of staffing levels, and (4) allocation of resources.

Based upon the methods that we recommended in our May 1993 report,[3] IRS developed and reported an estimate of $22 billion for collectible receivables as of September 30, 1992. Ultimately, though, systems must be developed to keep an accurate running record of IRS' receivables.

Important Revenue Information Is Unavailable or Unreliable

We were able to determine that IRS' total reported revenues of about $1.1 trillion were actually collected and deposited into Treasury accounts.[4] Although we were able to audit total revenue collections, we were not able to audit the components of revenue because IRS' systems could not provide the detailed transactions supporting the revenue balance, which is a serious limitation. IRS' systems also did not maintain and, thus, could not report the amounts of specific excise and social security taxes collected.

As a result, IRS could not provide Treasury the information needed to distribute excise taxes among the general revenue fund and the various excise tax trust funds based on collections, as required by law. Instead, IRS reported to Treasury the amounts of excise taxes assessed, and Treasury distributed revenue based on these amounts. Since total assessments exceed total collections, this practice, in effect, results in subsidies to the excise tax trust funds from general tax revenues. Over the past several years, such subsidies may have totaled several billion dollars. Also, the reported information gives the impression to decisionmakers that the excise taxes are generating more revenue than they actually do.

Similarly, IRS cannot determine the general revenue fund's subsidy to the social security trust fund. This subsidy occurs because, amounts distributed, which are by law to be based on wages earned, generally exceed social security taxes collected. However, IRS cannot precisely determine the subsidy amount because it does not account for the specific amounts of social security taxes collected. As a result, IRS cannot provide information on the subsidy to congressional committees and others

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[2] *Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements* (GAO/AIMD–93–2, June 30, 1993).

[3] *Financial Audit: IRS Significantly Overstated Its Accounts Receivable Balance* (GAO/AFMD–93–42, May 6, 1993).

[4] Our financial audit for fiscal year 1992 was not designed to address IRS' information on (1) the impact of tax policies on revenue, often referred to as "tax expenditures," and the process used by IRS to determine this information or (2) potential tax revenues, often referred to as the "tax gap."

who may be interested in monitoring the financial condition of the social security program.[5]

We identified additional fundamental deficiencies in IRS' analysis and summarization of its revenue-related records and in controls over the reliability of this information. Some examples follow:

—IRS' reports did not include transactions that were in process at the end of reporting periods because IRS did not analyze such transactions to determine which needed to be reported. As of September 30, 1992, in-process transactions, which could have affected IRS' reported accounts receivable, refunds payable, and other noncash accounts, exceeded $150 billion.

—IRS' current paper-based Federal Tax Deposit System for collecting payment data from businesses allowed numerous errors, primarily because the payment data and the related tax data were collected separately. Resolving such errors was both timeconsuming and costly to IRS and taxpayers.[6]

To address problems in revenue accounting, IRS is expanding the role of the CFO and is either studying, planning, or implementing various improvements to its systems and processes. Many of these improvement efforts, however, have not yet been defined or are not expected to be complete until well past the year 2000 because they are part of IRS' long-term Tax Systems Modernization effort.

Unreliable Records for Automated Data Processing Property

Inventory records for IRS' automated data processing (ADP) property were unreliable for managing and reporting on computer hardware and software. IRS had not instituted basic procedures to ensure that this information was current and accurate. Specifically, IRS (1) had not developed procedures to record acquisitions and disposals accurately and promptly, (2) did not effectively perform physical inventories, and (3) did not properly value computer resources. For example, a video display terminal costing $752 was valued in the ADP inventory records at $5.6 million, and telecommunications and electronic filing equipment, which IRS valued at a total of $84.2 million, was omitted altogether.

As a result of unreliable and incomplete records, IRS did not readily have the information it needed to (1) make computer support staffing decisions, (2) support development of budget requests, procurement decisions, and performance measurement information related to the use of computer assets, or (3) effectively manage maintenance contracts. For example, we found that IRS paid $36,000 for a maintenance contract for a minicomputer that had not been used for 3 years, because maintenance contract officers could not readily determine what equipment was still in use. Further, IRS did not maintain records of the costs of in-house software development which, when combined with ADP inventory information, would provide more complete accountability for ADP costs and assist in planning decisions.

For the last 3 fiscal years, IRS had budgeted acquisitions of property and equipment totaling $453 million. Planned future expenditures for ADP assets, approaching $9 billion under IRS' Tax Systems Modernization effort, increase the importance of accurate ADP asset records to IRS.

Inadequate Controls Over Computerized Taxpayer Data

Though heavily dependent on automated systems to process and safeguard taxpayer data, IRS did not adequately control access authority given to computer support personnel or adequately monitor employee access to this information. Further, controls did not provide reasonable assurance that only approved versions of computer programs were implemented.

Such weaknesses increase the risk of unintentional errors and fraud and may compromise the confidentiality of taxpayer information. For example, IRS- internal reviews found that some employees had used their access to monitor their own fraudulent returns, to issue fraudulent refunds, and to inappropriately browse taxpayer accounts. IRS is in the process of implementing new systems to monitor employee activities relating to computerized taxpayer information.

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[5] In our report entitled *Social Security: Reconciliation Improved SSA Earnings Records, But Efforts Were Incomplete* (GAO/HRD–92–81, September 1, 1992), we suggested that the Congress consider amending the Social Security Act to require that revenues credited to the social security trust funds be based on social security taxes collected.

[6] *Federal Tax Deposit System: IRS Can Improve the Federal Tax Deposit System* (GAO/AFMD–93–40, April 28, 1993).

Inadequate Management of Operating Funds

For years, IRS' systems used to process and account for spending of operating funds could not provide accurate and timely information needed to manage these funds. We were unable to audit approximately $4.3 billion, or 64 percent, of the reported spending of $6.7 billion from IRS' operating appropriations because IRS could not reconcile the total of detailed spending information in its outdated systems with summary amounts reported in such systems. The remaining $2.4 billion of reported spending in fiscal year 1992, which we audited, was processed by a new system installed in fiscal year 1992 in IRS' National Office and one region. This new system was implemented throughout IRS on October 1, 1992.

For the spending we were able to audit, IRS' systems and controls did not provide (1) a reasonable basis for determining compliance with laws governing the use of budget authority and (2) reasonable assurance that its disbursements were appropriate.

We found, for instance, that IRS had several billion dollars in unresolved cumulative gross differences between its records and Treasury's cash records at the end of the fiscal year. Also, as of September 30, 1992, IRS had not resolved $53 million in unmatched expenditures which were in a suspense account. To clear the account, IRS arbitrarily charged the $53 million to three of its appropriations (each appropriation was allocated one-third of the amount), causing IRS' reports to show that it had exceeded the budget authority for one of its appropriations. However, to eliminate the appearance that it exceeded such authority for this appropriation, IRS recorded an unsupported receivable from another appropriation.

Further, some disbursements were inappropriately processed because supporting documents were not adequately reviewed, related processing guidance was insufficient, and procurement and payment systems were not designed to automatically exchange information. In a random sample of 280 payments, for example, we found (1) 32 duplicate and overpayments totaling $0.5 million, 4 of which were part of our sample and 28 that were discovered in related documentation and (2) 112 payments totaling $17.2 million, for which complete supporting documentation could not be provided. As a result of these problems, IRS made improper payments, and reports used by its managers, Treasury, OMB, and the Congress to manage and oversee IRS' operations were unreliable.

IRS expects that its new system will provide up-to-date information that would enable it to better monitor available appropriations and determine whether funds are available before they are obligated—two problems identified during our financial audit. But even if the new system is successful, additional changes are needed to solve a number of the weaknesses we identified which were not intended to be addressed by the new system.

IRS' FMFIA Reporting

IRS did not disclose the overall severity of its internal control and accounting system weaknesses in its fiscal year 1992 report to Treasury under the Federal Managers' Financial Integrity Act (FMFIA) of 1982. Without adequate disclosure, the Congress and other users of the FMFIA report will not be aware of the extent of IRS' weaknesses and the efforts needed to correct them. We identified material weaknesses that IRS either did not include or, in our view, did not adequately disclose. For example, the serious problems we noted in the revenue area were largely undisclosed as were the problems in the management of operating funds.

In addition, some previously identified material weaknesses that were reported as corrected still exist because IRS did not address the fundamental causes of those weaknesses or ensure that corrective actions were effective. IRS' FMFIA process for identifying, disclosing, and correcting material weaknesses must be improved if IRS is to produce reliable information that top management can use to control costs and improve operations.

Actions by IRS to Improve Financial Management

Prior to fiscal year 1989, IRS had put neither substantial effort nor resources into rectifying the poor state of its financial management operations and no one at IRS was responsible for ensuring the integrity and efficiency of financial management and accounting systems agencywide. Responding to a recommendation in our 1988 report[7] on our general management review of IRS, which was a joint effort with

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[7] *Managing IRS: Actions Needed to Assure Quality Service in the Future* (GAO/GGD–89–1, October 14, 1988).

the agency, and the mandate of the CFO Act, IRS established financial leadership through the appointment of a CFO and an Assistant Commissioner (Finance)/Controller. These individuals and the support of IRS' top management have been key to the progress to date.

Among the actions IRS has taken are to (1) significantly increase its CFO staff, (2) implement agencywide, in fiscal year 1993, a new integrated accounting and budget system, and (3) begin development of a cost management system to enable better performance measurement and reporting on operating performance. Also, IRS is studying, planning, or implementing various additional improvements to its systems and processes.

IRS will continue to face major challenges in developing meaningful and reliable financial management information and in providing effective internal control as envisioned by the CFO Act. It will take a significant and sustained commitment by IRS management, particularly by the CFO and CFO staff, to successfully implement the improvement initiatives now under way.

We believe IRS is making progress because it has had a sustained commitment to improving the management of its operations. The past several IRS Commissioners adopted a consistent management improvement agenda that we helped IRS initially frame as part of our 1988 general management review. Management's response to the findings of the general management review, similar to IRS' work to address the findings of our financial audit, has been most encouraging and signifies an organization willing to recognize its problems and attempt to do something about them. My hope is that we will see this type of management involvement and commitment across government. In my view, only in this way will agencies achieve the level of improvement that is needed to successfully implement the CFO Act and to improve overall management of agency programs and operations.

SERIOUS WEAKNESSES EXIST IN CUSTOMS' FINANCIAL MANAGEMENT OPERATIONS AND CONTROLS, AND MANAGEMENT IS ACTING TO ADDRESS THESE PROBLEMS

I will now discuss some of the more serious problems we identified through our financial audit of the Customs Service.[8]

Weak Accountability for Seized Property and Special Operations Documents

Customs reported $542 million in seizures during fiscal year 1992 and an ending balance of $489 million in seized property in its financial statements. The policies and procedures the agency established to control seized property, though, were not consistently and effectively implemented. We identified weaknesses in internal controls throughout Customs' seizure process, from the time property was seized to the time of its disposal. Seized property was vulnerable to theft or loss, which could result in financial loss to the government or danger to the public.

The following are examples of control breakdowns:

—The transfer of seized property from seizing officers to seizure custodians for safeguarding was often delayed. Over 50 percent of the 118 items we tested were not transferred within Customs' prescribed 2-day maximum—the average was 35 days. In one instance, about one-half pound of heroin was held by a seizing officer from August 11, 1992, the date of the seizures until March 16, 1993, when we visited the Customs' district involved. No one could explain the reason for the delay.

—Seized drugs were not properly weighed and tested, creating an environment where drugs could be stolen without detection. For instance, although Customs had established procedures to weigh drug seizures, we found a case where a shortage of 1,850 pounds of seized marijuana could not be accounted for. Customs was unable to explain the discrepancy other than to state that the initial weight assigned to the marijuana was probably an estimate and that the seizure had not been weighed as required at the time of receipt.

—Storage facilities were not properly protected. At 14 of the 20 Customs' seized property storage facilities we visited, we observed that unaccompanied seizure custodians had access to vaults. None of the 20 Customs districts we visited had security cameras in their vaults, and 2 sites containing large bulk quantities of drugs had open physical access in full public view.

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[8] *Financial Audit: Examination of Customs' Fiscal Year 1992 Financial Statements* (GAO/AIMD–93–3, June 30, 1993).

Further, Customs did not adequately control millions of dollars in funds advanced to its agents for special operations, such as undercover work and payments to informants, or the sensitive documents related to these advances. For advances, Customs' accounting records had to be adjusted from $37 million to $19 million to show the correct balance at year-end. More serious though, sensitive documents supporting special operations transactions were not adequately safeguarded. At Customs' National Finance Center, sensitive documents were routinely stored in an open filing cabinet in an unlocked room or were left unattended on a desk. Failure to adequately protect these documents could threaten the safety of informants and Customs' agents, compromise important relationships with informants, and undermine Customs' credibility.

Inadequate Accounting for and Controlling of Accounts Receivable

The $828 million Customs reported as accounts receivable as of September 30, 1992, was inaccurate and incomplete. Customs' internal controls over accounts receivable were so poor that we could not gain assurance that all valid receivables were included in its reported amounts. Further, Customs' reported amount did not include certain valid receivables, included some receivables at a net amount instead of gross, and included some receivables which could not be supported. For example, the reported accounts receivable included only $26 million for fines and penalties cases. In a relatively small sample, we found fines and penalties cases with an assessed value of $78.7 million which should have been included but were not.

Also, Customs had not developed a reliable methodology for estimating the amount of its receivables that is likely to be collected. Customs' methodology was flawed because it considered primarily historical collection experience but did not consider the debtor's current ability to pay. Our review of $403 million of valid receivables as of June 30, 1992, showed that Customs' estimate of the uncollectible amount of these accounts receivable was understated by about $41 million.

In addition, efforts to collect delinquent debt were hampered by missing documents. In our sample of 966 cases, Customs could not locate 144 key documents, involving 127 cases, needed to support its claims against the importer or surety. In addition, Customs did not effectively monitor bond coverage which gave rise to delinquent and, in some cases, uncollectible accounts receivable. In one instance, a petroleum importer, with 15 outstanding bills totaling about $3.1 million, had a continuous surety bond of only $400,000. Customs pursued collection from the surety and collected the bond amount. However, the remaining $2.7 million was not covered by the bond and is most likely uncollectible as the importer iS more than 4 years delinquent in paying this debt.

Finally, large differences existed between the amounts of fines and penalties assessed, mitigated, and collected. Overall, Customs collected pennies on a dollar of assessed fines and penaltie5. Violators, who are aware of these differences and Customs' practice of mitigating most assessments, may routinely petition for mitigation, requiring Customs to devote large amounts of resources to the mitigation process. While Customs does not routinely report data that correlate individual assessments to collections, we found that only a small fraction is being collected. As a measure of the potential difference, during the past 2 fiscal years, Customs assessed fines and penalties totaling approximately $7.9 billion and collected only about $87 million for various fines and penalties cases, including cases opened in earlier years.

According to Customs' officials, such differences result primarily from (1) the statutory requirements that Customs assess fines and penalties in large amounts and (2) Customs' practice of mitigating most accounts to nominal amounts. We found that some assessments are mitigated because Customs did not have sufficient documentation at the time of assessment and later mitigated the assessment to reflect documentation provided by the importer. For example, Customs assessed a penalty amount of about $4.4 million to an importer for allegedly fraudulently undervaluing merchandise being imported. The importer filed a petition with Customs and provided additional information, and the penalty was reduced to $150,000.

Weaknesses Over Import and Drawback Verification Create Opportunities for Lost Revenue and Fraud

Customs relies to a great extent on importers and brokers to voluntarily report and assess the amount of duties, taxes, and fees owed on imported merchandise. We found no significant internal controls to ensure that merchandise entering the United States was identified and the proper duty assessed. Based on certain audit tests, we were able to conclude that Customs' reported revenues of $20.2 billion for fiscal year 1992 approximate revenues collected from importers who voluntarily reported and paid amounts owed. However, because of the potential for goods to enter and not be identified, we cannot give any assurance that the $20.2 billion represents all revenues which Customs should have collected for fiscal year 1992. Customs recognizes this problem and has established a project to improve importer compliance and target inspections for trade enforcement purposes. It will, though, take a significant effort to adequately address the broad scope of problems in this area.

Furthermore, our review of Customs' duty refund (drawback) policies and procedures showed that serious control weaknesses existed throughout the process. Customs makes refunds to claimants for 99 percent of duties paid when the related imported merchandise is subsequently exported or destroyed. Customs reported that it made almost half a billion dollars in drawback payments during fiscal year 1992. However, we found that procedures were inadequate to prevent excessive or duplicate payments or detect fraudulent claims. Specifically, Customs did not (1) adequately assess the validity of a drawback claim and track the amount of drawback paid against an import entry, (2) establish sufficient review procedures to ensure that a claim was accurate, (3) ensure that required bonds were adequate, and (4) ensure that only authorized claimants received accelerated[9] drawback payments.

In the absence of appropriate controls, Customs' extensive reliance on voluntary compliance of the trade community to accurately report duties owed and drawbacks claimed creates an environment where the Federal Government could lose substantial amounts of revenue.

Customs Lacked Adequate Accountability for Property

Customs lacked adequate accountability for property which it valued at $710 million at September 30, 1992. About 85 percent of this amount consisted of equipment such as aircraft, vehicles, and vessels. For years, Customs was unable to reconcile its accounting records with the related detailed subsidiary property records. In fiscal year 1992, Customs made a substantive effort to reconcile these records, which resulted in net adjustments that totaled $115 million. Some of these adjustments, though, were not supported by identifiable transactions and were made to force these records to agree. Customs did not know whether the adjustments represented property that was simply incorrectly accounted for or, was lost, misappropriated, or stolen.

Also, Customs' fiscal year 1992 physical inventory of equipment was ineffective. We found, for example, $6.2 million of computer equipment on hand which was not included in the property records. Further, Customs was unable to support the values assigned to over 50 percent of the 650 property items we sampled and tested. The value assigned to many items appeared to be estimates. In the cases where Customs was able to provide documentation, 12 percent of the property items were improperly valued, resulting in an estimated net understatement of at least $4.7 million.

Customs' FMFIA Reporting

Similar to IRS, Customs did not report the overall severity of its internal control and accounting system weaknesses in its fiscal year 1992 FMFIA report. Its report did not include or did not adequately disclose the seriousness of the problems identified in our audit. Customs' FMFIA process for identifying, disclosing, and correcting material weaknesses must be improved if the agency is to produce reliable information that top management can use to control costs and improve operations.

Actions by Customs to Improve Financial Management

Customs has made strides in addressing long-standing financial management problems. For years, until the passage of the CFO Act, Customs, like IRS, lacked financial management leadership with sufficient expertise, responsibility, and authority to ensure that its financial systems, processes, and internal controls fully supported its financial information needs. Over the last 2 years, through the strong support of the Commissioner and Customs' top management, the agency has put in place a CFO structure and given the CFO the authority and responsibility necessary to begin to correct many of the problems identified in our audit. During 1992, for instance, the agency installed a new core general ledger system which became effective October 1, 1992.

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[9] Accelerated drawback payments were made to authorized claimants prior to Customs reviewing and verifying the validity and accuracy of the claim. Nonaccelerated claims are paid after Customs reviews them. Therefore, accelerated payments represent a greater risk than nonaccelerated payments.

Customs is either studying, planning, or implementing various improvements to its systems and processes. It is in the process of redesigning its Automated Commercial System, which was developed to automate information on Customs' program operations and is used to account for revenue collected, and it has begun development of a new cost accounting system. Customs has also begun to modify its methodology for estimating the collectibility of its accounts receivable and has made positive strides towards addressing its debt collection problems. Further, Customs has taken steps to resolve long-standing problems in its property records and is planning additional efforts.

The success of Customs' ongoing ADP modernization efforts and planned procedural improvements will be critical to improving its financial management systems and internal control structure. Many of these efforts, though, are not expected to be complete for several more years. As a result, it will take a significant and sustained commitment by Customs' management, particularly by the CFO and the CFO staff, to build on efforts now under way to develop new systems and put proper controls in place.

REACHING FOR FINANCIAL MANAGEMENT REFORM: SUCCESSFUL IMPLEMENTATION OF THE CFO ACT MUST BE A HIGH PRIORITY

This leads me to the broader issue of ensuring successful government-wide implementation of the CFO Act. As discussed in our December 1992 transition series report on *Financial Management Issues* (GAO/OCG–93–4TR), widespread financial management weaknesses are crippling the ability of our leaders to effectively run the Federal Government. Reducing the federal deficit requires monumentally difficult decisions. If our government is to make these decisions in an informed manner, it must have better financial information. Also, our citizens should be provided meaningful information that allows them to judge the performance of their government and controls that help guarantee fundamental accountability. Because credible financial data are not available today, public confidence in the Federal Government as a financial steward has been severely undermined.

There is no magical formula to solve the Federal Government's financial management problems. The issues are very complex, deeply rooted, and involve the largest entities in the world, which have no counterparts in the private sector—the Federal Government is clearly different. Nevertheless, successful financial management reform can and must be achieved.

The CFO Act, enacted under the leadership of this Committee and the House Committee on Government Operations, provided the needed foundation. This landmark legislation is the most comprehensive financial management reform package in 40 years—but it must be fully and effectively implemented. The CFO Act is now 2½ years old. Many important initiatives are under way and planned, and I am most pleased that the basic concepts are taking root. But a much greater sense of urgency is essential to successfully implement needed reforms and to ensure that the huge potential savings to the taxpayer from the resulting improvements in the efficiency and effectiveness of government are realized as promptly as possible. I would now like to highlight these critical actions.

Ensuring Sustained High-Level Priority Attention to Resolve Problems

Only through consistent and continuous attention from the highest levels of government and the Congress, including agency CFOs with requisite skills and experience and the needed powers and authority to get the job done, will we see the results that are possible. Without decisive action by the new administration and strong oversight and support by the Congress, efforts to reform financial management will falter. There must be a sense of urgency. Changing a government culture that has not always seen financial management as important is difficult, especially if there is not a continuity of effort or if this change is not perceived as important.

Essential to success will be the President making financial management reform a high priority in the administration, and I am hopeful this will emerge as one of the top action items of the National Performance Review. The President must hold agency heads accountable for successfully implementing the CFO Act. There has to be an increased emphasis on professional management. In my view, the success of financial management reform is critical to any effort to reinvent government.

Agencies must give high-level attention to financial management improvements. For example, the recent announcement by the Department of Defense that it had established a senior management steering committee, chaired by the Deputy Secretary, to bring together financial, program, and information management, was encouraging. Agency leadership has to provide an appropriate framework for integrating accounting, program, and budget systems and data in order to develop more useful and relevant information for decision-making and to break down traditional barriers between program and financial management. Further, the central financial management agencies—OMB, Treasury, and GAO—must expedite sorely needed accounting, financial reporting, cost, and systems standards.

The CFO Act established a Controller in OMB to provide overall leadership and CFOs to direct and control financial management activities in major departments and agencies. A highly qualified Controller is needed to steer this effort, with the authority to lead the CFOs in the major departments and agencies and the resources to do the job. The administration must also appoint agency CFOs who are highly qualified financial management professionals, with the right mix of properly defined duties and full authority for traditional financial management functions, including budgeting. At most agencies, the CFO has not yet been appointed.

Expanding Audited Financial Statements to the Entire Federal Government

As I have stated on many occasions, I am firmly convinced of the value of audited financial statements. As I discussed earlier, the results of the pilot financial audits at Defense and the civilian agencies further reinforce this belief.

On June 25, 1993, OMB Bulletin 93–18 extended the pilot program for audited financial statements at 10 agencies for 3 years and established March 1 as the new due date for the issuance of all audited financial statements. In issuing this new bulletin, the Director of OMB stated:

> "The preparation and audit of financial statements has provided significant financial and related information, identified and stimulated correction of deficiencies in the agencies' financial systems, and improved understanding of the agencies' financial condition and results. Accordingly, it is beneficial to continue and expand the audited financial reporting process."

I fully support the OMB Director's extension of the pilots and establishment of a March 1 reporting date to tie in with the budget cycle. OMB's continuing strong support of audited financial statements and the leadership of its Office of Federal Financial Management have been very important to the success of this program.

To further build on this success, it is now time to expand the requirements for agency level audited financial statements beyond the 10 pilots to cover all the agencies identified in the CFO Act. This could be phased in over the next 3 years and would ultimately enable preparation of financial statements for the government as a whole, which GAO would audit. For the first time, the American public would be given an accountability report from its government.

We believe it would be best for this requirement to be anchored in legislation. The legislative mandate in the CFO Act for audited financial statements has been a catalyst for the important results we have seen to date in moving agencies to a higher level of financial accountability. While administrative requirements to prepare financial reports date back to the 1950s, the legal force of the CFO Act, together with the interest and involvement of this Committee and the House Committee on Government Operations, is what finally moved this effort ahead.

Also, the preparation of audited financial statements, including required performance information on the results of operations, would support the implementation of the Government Performance and Results Act of 1993. In my view, implementation of this important new legislation can be greatly aided with good cost and operating performance information that audited financial statements under the CFO Act are intended to provide.

Making Wise Investments in Systems and Personnel to Rebuild Financial Management Infrastructures

Today, it is well acknowledged that current financial systems across government are in extremely poor condition, despite spending billions of dollars over the years on improvement efforts. IRS and Customs, for example, struggled in preparing reliable financial statements primarily because of severely weak systems. This has to be overcome through wise investments in modern systems that enable streamlined operations and have a dollar pay-off in terms of better information and better efficiency. While investment in new systems is essential, billions of dollars are already being spent on systems every Year—the money just has to be better invested in carefully developed systems that will meet government information needs.

The CFO Act calls for integrated systems, meaning financial and operating systems that are interconnected to support both agency business plans and management information needs. There must be increased emphasis on using information resource management to facilitate agency reengineering projects. Reform cannot be viewed merely as further automating existing processes. Rather, those processes must be simplified, redirected, and reengineered.

An equally important step is breaking down traditional barriers between program and financial management so that financial management supports programs, missions, and business lines. For example, the serious problems IRS faced in accounting for its receivables stemmed in large part from a system that was designed to capture information for enforcement and collection activities and was not properly tied to financial reporting. Further, efficiencies could be gained through more standard systems and more "cross servicing" in which one agency provides accounting services (such as payroll and disbursing) to another agency. The development and use of government-wide systems development standards to better guide system design and implementation efforts would be a vital component in such efforts.

The Federal Government must address immediately the serious problem of attracting and retaining well-qualified financial management personnel. Agencies reported a significant need to upgrade their financial management staff capabilities. In our financial audits, we have found that bad systems are made even worse because people do not properly process transactions. We have identified tens of billions of dollars of accounting errors that could have been avoided if there had been more discipline in following existing policies and procedures. Financial managers must upgrade their training efforts to increase professional skills.

Implementation of new systems that eliminate the duplicative and manual processes that agency systems require today should enable agencies to decrease the size of their financial management staffs. But, they may need more skilled professionals such as financial analysts and cost and systems accountants. Further, to ensure a cadre of professional financial managers for a government that is the largest financial entity in the world, we support mandatory continuing professional education for all financial managers similar to the requirement now in place for auditors.

Fostering Reforms Through Strong Congressional Oversight and Support

I have spoken many times about the importance I place on annual congressional oversight hearings of agency management. Managers must be held accountable for results. The annual agency CFO report, which includes the audited financial statements, together with the reporting required under FMFIA, can provide a baseline for such hearings.

In the case of FMFIA, these reports have to be meaningful and must be used or else they will not be taken seriously. As I testified on July 1st, we had major problems with the Department of Defense's most recent FMFIA report, and earlier I cited the problems we identified with IRS' and Customs' FMFIA reporting. Greater accountability can be established through reporting that combines the agency CFO and FMFIA reports and focuses on outcomes and results which are scrutinized by annual congressional oversight hearings.

Finally, in difficult budget times, and where the pay-off may not be immediate, funding for financial management improvements will need to be viewed as investments. For the CFO Act to succeed, the Congress will have to provide the necessary funding support through investments in modern systems, personnel staffing and development, and expanded financial reporting and auditing.

In closing, I want to emphasize that the CFO Act has had an important impact in changing perceptions about the need for good financial management, and agencies have made improvements and are working in response to the act to significantly strengthen their financial processes and systems. But it will take a great deal of commitment and hard work to achieve the full potential and objectives of the act and turn around long-standing neglect of financial management. Our financial audits at IRS and Customs, for example, have identified major problems that will need management's continuing top-level attention and their support of the CFO. Top management's recognition that they have serious problems and efforts to establish a viable CFO structure in their agencies are an important beginning to a difficult challenge.

Shifting now to a government-wide perspective, an intensified sense of urgency will be needed. We are at a critical juncture in implementation of the CFO Act. Financial management reform must be a high priority of the President and the Congress. Changing a government culture that has not always seen financial management as important is difficult, especially if there is not a continuity of effort or if this change is not perceived as critical. We stand ready to work with the Committee in any way we can. Attached to my statement is a summary of the needed actions which were included in our Financial Management Issues transition series report. (See attachment II.) I view implementation of the CFO Act as essential to establishing accountability in the Federal Government, which has been one of my fundamental goals as Comptroller General.

Mr. Chairman, this concludes my statement. I will be glad to answer any questions that you or the other Members of the Committee may have at this time.

ATTACHMENT I

FINANCIAL AUDITS AT OTHER CIVILIAN AGENCIES DEMONSTRATE THE BENEFITS OF PREPARING AGENCY FINANCIAL STATEMENTS

In addition to IRS and Customs, other civilian agencies, including those participating in the CFO Act pilots, have realized important results from audited financial statements. The following highlights two examples: (1) the Department of Education, where GAO has just issued its audit report on the student loan program and (2) the Social Security Administration (SSA), which has issued audited financial statements since 1988.

Education's Student Loan Program Has Serious Financial Management Problems

With a reported $63 billion in outstanding loan guarantees at September 30, 1992, the Department of Education's Federal Family Education Loan Program (FFELP), referred to as the guaranteed student loan program, is the largest postsecondary education loan program of the Federal Government due to a history of program mismanagement and the significant increase in loan defaults since the program's inception—gross loan defaults were about $3 billion in fiscal year 1992—the FFELP has been on our list of high-risk programs since we began this designation in 1990. We have been especially concerned with the program's structural flaws and the lack of adequate incentives that some participants have to prevent defaults and to operate more efficiently.

Education has put forth a substantial effort in implementing the CFO Act and in preparing the first comprehensive financial statement for the FFELP. As with IRS and Customs, this effort was hampered because Education's systems were not designed to provide the financial management information needed to effectively manage and report on the FFELP's operations.

Education fully cooperated with us and began significant efforts towards developing such information. However, because critical supporting information for almost $14 billion of recorded liabilities for loan guarantees and related accounts was unreliable, we were unable to express an opinion on the reliability of the FFELP's fiscal year 1992 financial statements taken as a whole.[10] Compounding this problem, internal controls were not designed and implemented to effectively safeguard assets and assure that there were no material misstatements in the financial statements. For example:

—Education is not able to ensure that billions of dollars in program payments to lenders and guaranty agencies are accurate;

—FFELP participants, including banks and other financial middlemen, operate under misplaced incentives and conflicts of interest that result in waste and abuse;

—optimistic projections of loan defaults have contributed to a nearly $3 billion shortfall in Education's budgetary estimates of program costs in fiscal years 1992 and 1993; and

—Education did not have adequate financial reporting processes and procedures.

Under the leadership of the CFO's office, Education has made progress in addressing some of these long-standing deficiencies. Efforts include intensifying its reviews of lenders and guaranty agencies and developing and reconciling subsidiary ledgers for the FFELP which, if successful, will increase program accountability. A strong CFO and a continuing firm commitment from top management is necessary if Education is to sustain this progress.

The Social Security Administration Has Made Improvements in Financial Management and Reporting

SSA has issued audited financial statements for the past 6 years. Over this period, SSA has improved the usefulness, timeliness, and accuracy of its financial

[10] *Financial Audit: Federal Family Education Loan Program's Financial Statements for Fiscal Year 1992* (GAO/AIMD–93–4, June 30, 1993).

management information. We believe that the progress to date at SSA is a result of the strong leadership and commitment from the SSA CFO.

For the past 3 years, SSA's financial statements have included performance information which shows actual performance for the last 4 years for many of the key goals and objectives outlined in the Social Security Strategic Plan. The Strategic Plan identifies SSA's strategic priorities and service delivery goals and objectives for the year 2005, including the consequences of not achieving these objectives. The performance section of the financial statements thus can serve as a "report card" on how SSA is progressing towards its strategic goals and objectives.

Another factor that has increased the usefulness of SSA's fiscal year 1992 statements is that SSA issued them in February 1993, in time for use in congressional appropriation hearings. The timely release of these financial statements serves as a model for other large agencies.

Except for unresolved differences in wage certification and the accuracy of SSA's accounts receivable (benefit overpayments), the Department of Health and Human Services' Inspector General (IG) reported that the 1992 SSA financial statements were fairly stated. During fiscal year 1992, SSA made improvements that allowed the IG to remove prior years' opinion qualification on property management.

Although wage certification, accounts receivable, and other issues remain unresolved, significant progress has been made in SSA's financial management and reporting. We believe that through continued strong leadership from the CFO, SSA can effectively address these concerns in the future.

ATTACHMENT II

TAKING FURTHER ACTIONS TO EFFECTIVELY IMPLEMENT THE CFO ACT

The framework of the CFO Act offers great hope for achieving better government management. But while important progress has been made, the government is a long way from achieving the act's objectives. A sense of urgency is needed to solve the problems.

The following actions, which are discussed in GAO's transition series report on *Financial Management Issues* (GAO/OCG–93–4TR), are essential to successfully implementing needed reforms.

The President should

—make financial management reform a high priority in the administration;
—hold agency heads accountable for successfully implementing the CFO Act and for attaining good financial management, effective internal controls, and sound financial reporting that ties together financial and program information;
—sustain a high level of financial management leadership in OMB and provide adequate resources to the Office of Federal Financial Management; and
—appoint to agencies' CFO positions only highly qualified individuals who (1) have extensive practical experience and demonstrated ability in financial management, as mandated by the CFO Act, and (2) meet the qualification requirements established by OMB.

The Director of the Office of Management and Budget should

—closely monitor agencies' adherence to existing accounting policies and procedures in order to improve data accuracy and promptly take necessary remedial action when agencies are not doing the job;
—expand OMB's ability to oversee and, where needed, direct agencies' actions to correct long-standing internal control weaknesses and high-risk problems, especially in cases in which results have not been forthcoming;
—foster a strong program of financial statement auditing by supporting (1) needed funding for the Inspectors General and (2) audit requirements that meet the broad objectives of the CFO Act;
—promote and closely oversee agencies' efforts to build first-class financial management infrastructures—both personnel and systems;
—provide an appropriate framework for integrating accounting, program, and budget systems and data to (1) develop more useful and relevant information for decision-making and oversight and (2) break down traditional barriers between program and financial management;
—continue to work with GAO and the Department of the Treasury to develop accounting standards and concepts to meet the unique needs of the Federal Government;
—expand financial reporting to encompass the full range of accountability, which includes operating results, program performance measurement, and cost information; and

—establish minimum levels of continuing professional education requirements for financial management personnel and work with the CFO Council to develop and expand training programs.

The Congress should

—amend the CFO Act to require audited financial statements on an annual basis for all major agencies and for the government overall;
—focus closely on CFO appointments to ensure the qualifications of these individuals;
—conduct annual oversight hearings using the CFOs' annual reports and audited financial statements; and
—provide necessary funding support for financial reform efforts through investments in modern systems, personnel development, expanded financial reporting and auditing, and a strengthened Office of Federal Financial Management.

United States General Accounting Office

GAO

Report to the Congress

June 1993

FINANCIAL AUDIT

Examination of IRS' Fiscal Year 1992 Financial Statements

GAO/AIMD-93-2

GAO

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-250977

June 30, 1993

To the President of the Senate and the
Speaker of the House of Representatives

This report presents the results of our efforts to audit the Principal Financial Statements of the Internal Revenue Service for fiscal year 1992. As part of this effort, we evaluated the IRS' internal controls and its compliance with laws and regulations related to the financial statements. Pursuant to the Chief Financial Officers Act of 1990 (Public Law 101-576), IRS was required to prepare agencywide financial statements for fiscal year 1992 and have them audited. As authorized by the act, we attempted to perform an audit of these statements.

We were unable to express an opinion on the reliability of IRS' 1992 Principal Financial Statements because critical supporting information was not available. Where information was available, we found that it was generally unreliable.

In addition, we found that IRS' internal controls did not effectively safeguard assets, provide a reasonable basis for determining material compliance with relevant laws and regulations, and assure that there were no material misstatements in the Principal Financial Statements. However, we were unable to test all significant controls due to the limitations on data availability mentioned above.

Further, we found no instances of material noncompliance with laws and regulations during fiscal year 1992. However, we could not test compliance with many laws that we considered necessary to test because of the ineffective internal controls and limitations on data availability.

The results of our audit of the IRS are discussed in greater detail in several reports that we have either issued or are planning to issue.

We are sending copies of this report to the Commissioner of the Internal Revenue; the Secretary of the Treasury; the Director of the Office of Management and Budget; the Chairmen and Ranking Minority Members of the Senate Committee on Governmental Affairs, the Senate Committee on Finance, the House Committee on Government Operations, the House Committee on Ways and Means, the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, the Subcommittee on Oversight, House Committee on Ways and Means, and the Joint Committee on Taxation; and other interested parties. Copies will be made available to others upon request.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

Contents

Abbreviations

ADP	automated data processing
CFO	Chief Financial Officer
FMFIA	Federal Managers' Financial Integrity Act
IRS	Internal Revenue Service
OMB	Office of Management and Budget

GAO

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-250977

June 30, 1993

To the Commissioner of Internal Revenue

In accordance with the Chief Financial Officers (CFO) Act of 1990, the Internal Revenue Service (IRS) prepared the accompanying Principal Financial Statements for the fiscal year ended September 30, 1992. IRS is the largest revenue collector for the federal government, reporting tax collections of $1.1 trillion for fiscal year 1992. While IRS has historically filed certain unaudited financial information with the Department of the Treasury, this was the first time that IRS prepared a comprehensive set of Principal Financial Statements. Preparation of these statements presented substantial challenges to IRS. This undertaking was made more difficult because existing IRS systems were not designed to provide the meaningful and reliable financial management information needed to effectively manage and report on IRS' operations. In accordance with the CFO Act, we elected to perform an audit of these statements and related internal controls. IRS fully cooperated with us and has made progress towards developing reliable information.

The results of our audit are summarized as follows.

- We are unable to express an opinion on the reliability of the fiscal year 1992 Principal Financial Statements of IRS because critical supporting information was not available. Where supporting information was available, we found that such information generally was unreliable. As a result, internal and external reports that were based on this information may be unreliable.
- In our opinion, internal controls were not properly designed and implemented to effectively safeguard assets, provide a reasonable basis for determining material compliance with laws governing the use of budget authority and other relevant laws and regulations, and assure that there were no material misstatements in the Principal Financial Statements. However, we were unable to evaluate and test all significant internal controls due to the limitations on the availability of supporting information mentioned above.
- The ineffective internal controls, lack of supporting information, and unreliable information also affected the reliability of a significant amount of the information contained in the Overview to the Financial Statements and Supplemental Financial and Management Information. Much of this information was either derived from the same sources as the information presented in the Principal Financial Statements or lacked adequate

controls over its reliability. Consequently, this information may be unreliable.

- Our tests for compliance with selected provisions of laws and regulations disclosed no material instances of noncompliance; however, we could not test compliance with many laws that we considered necessary to test because of the ineffective internal controls and limitations on the availability of supporting detail that are discussed above. With respect to laws and regulations that we were able to test, our limited tests would not necessarily detect all material instances of noncompliance. However, our work identified some instances of noncompliance with certain provisions of the Internal Revenue Code relating to distribution of excise taxes.

Although our audit has identified a number of critical financial management problems that demand attention, we believe that there is a high potential return on investment in the financial management function. IRS has made important strides in addressing long-standing financial management problems. But the process of change has just begun. Prior to fiscal year 1989, IRS had put neither substantial effort nor dollars into rectifying the poor state of its financial management operations and no one at IRS was responsible for ensuring the integrity and efficiency of financial management and accounting systems agencywide. IRS established financial leadership through the appointment of a CFO and an Assistant Commissioner (Finance)/Controller in fiscal year 1990. Additionally, IRS has:

- significantly increased its CFO staff to address its long-standing critical shortage of accounting personnel;
- implemented agencywide, in fiscal year 1993, a new integrated accounting and budget system to replace an unreliable system;
- introduced quarterly, rather than annual, budget allocations for its managers for better control over spending;
- begun development of a new cost management system, designed to provide information on the component costs of IRS' operations to support informed financial management decisions; and
- converted to the National Finance Center's payroll system to replace an unreliable payroll system and provide more detailed payroll and benefit cost information.

IRS continues to face major challenges in developing meaningful and reliable financial management information and in providing effective internal controls, as envisioned by the CFO Act. It will take a significant and sustained commitment by IRS management, particularly by the CFO and CFO staff, to build on efforts now underway to develop such information and put proper controls in place. As evidence of this commitment, IRS has already implemented or begun to take steps to correct some of the problems identified in this financial audit. For example, we found that IRS historically reported significantly overstated accounts receivable balances. In response, IRS based its estimate of accounts receivable at September 30, 1992, on the methodology we recommended as a short-term measure until IRS can develop systems and internal controls that will routinely provide reliable information about valid and collectible accounts receivable.

Significant Matters

The significant matters noted in our audit relate to revenue, tax accounts receivable, property and equipment, management of operating funds, computer controls, seized assets, and reports required by the Federal Managers' Financial Integrity Act (FMFIA). We found that IRS had material weaknesses in internal controls over each of these areas that could lead to material losses of assets, noncompliance, or misstatements in the Principal Financial Statements. Also, as noted below, many of the material weaknesses that we identified were not included in IRS' 1992 FMFIA report, which is to identify all such weaknesses. We have issued two reports[1] and plan to issue additional reports that describe these significant matters in detail.

Revenue

We were able to determine that IRS' total reported revenues of about $1.1 trillion were collected and deposited into Treasury accounts. However, we were not able to audit the components of revenue and most of the revenue-related balances reported in IRS' Principal Financial Statements because IRS' revenue accounting system had not been programmed to generate a computer file or listing of the detailed transactions, such as assessments, collections, abatements, refunds, and interest, recorded during the year. Without a complete file or listing of transactions supporting these balances, we were not able to perform audit procedures we considered necessary. IRS is developing computer programs to provide this information for the fiscal year 1993 audit. Due to the limitations on the availability of supporting information, we also were unable to adequately evaluate and test revenue-related controls.

A related effect of IRS' inability to retrieve files or listings of transactions is that IRS cannot readily determine, for a given period, the total amount of a

[1]Federal Tax Deposit System: IRS Can Improve the Federal Tax Deposit System (GAO/AFMD-93-40, April 28, 1993) and Financial Audit: IRS Significantly Overstated Its Accounts Receivable Balance (GAO/AFMD-93-42, May 6, 1993).

specific type of transaction, such as penalties or interest, or analyze its components. Such information would be useful to IRS in managing its collection and enforcement activities.

Also, we found that IRS' systems do not maintain and, thus, cannot report the amounts of specific excise taxes collected. As a result, IRS cannot provide Treasury the information needed to distribute these taxes among the general revenue fund and the various excise tax trust funds based on collections, as required by law. Instead, IRS reports to Treasury the amounts of excise taxes assessed, and Treasury distributes revenue based on these amounts. Since total assessments exceed total collections, this practice, in effect, results in subsidies to the excise tax trust funds from general tax revenues. Over the past several years, such subsidies may have totalled several billions of dollars.

Similarly, IRS cannot determine the general revenue fund's subsidy to the social security trust fund. This subsidy occurs because amounts distributed, which by law are to be based on wages earned, generally exceed social security taxes collected. However, IRS cannot precisely determine the subsidy amount because it does not account for the specific amounts of social security taxes collected. As a result, IRS cannot provide information on the subsidy to congressional committees and others who may be interested in monitoring the financial condition of the social security program.[2]

Also, the agencies who manage programs that depend on trust fund revenues have little ability to (1) verify that the distributions their funds receive are correct and (2) assist in tax enforcement efforts because most receive virtually no related information from IRS, some of which IRS is currently precluded by law from providing.

Further, GAO identified fundamental deficiencies in IRS' analysis and summarization of its revenue-related records and in controls over the reliability of certain supporting transactions. These deficiencies affect the reliability of historical information reported either (1) routinely to the Office of Management and Budget (OMB), Treasury, and in the President's annual budget submission to the Congress or (2) on an ad hoc basis to

[2]In our report entitled Social Security: Reconciliation Improved SSA Earnings Records, but Efforts Were Incomplete (GAO/HRD-92-81, September 1, 1992), we suggested that the Congress consider amending the Social Security Act to require that revenues credited to the social security trust funds be based on social security taxes collected.

congressional committees, the media, and others. Examples of these problems are listed below.

- IRS' reports did not include transactions that were in process at the end of reported periods in its accounts receivable, refunds payable, and other noncash accounts, because IRS did not analyze such transactions to determine which needed to be reported. As of September 30, 1992, such transactions exceeded $150 billion.
- IRS' current paper-based Federal Tax Deposit system for collecting payment data from businesses allows numerous errors, primarily because the payment data and the related tax data are collected separately. Resolving such errors is both time-consuming and costly to IRS and taxpayers.
- The lack of prompt reconciliations between employee and employer wage records has delayed the recording of revenue adjustments and detection of taxpayer fraud.
- Interest on certain types of accounts receivable was calculated incorrectly, primarily because IRS had not implemented computer programs to routinely perform the required complex calculations and the resulting manual calculations were often erroneous.
- Adjustments to summary-level revenue records were not subject to consistent supervisory review, which increased the risk that erroneous entries may be posted.

To address these problems in revenue accounting, IRS is expanding the role of its CFO and is either studying, planning, or implementing various improvements to its systems and processes. However, many of these improvement efforts have either not yet been defined or are not expected to be complete until well past the year 2000 because they are part of IRS' long-term Tax Systems Modernization effort.

Our audit for fiscal year 1992 was not designed to address IRS' information on (1) the impact of tax policies on revenue, often referred to as "tax expenditures," and the process used by IRS to determine this information or (2) potential tax revenues, often referred to as the "tax gap." We have previously issued many reports on the individual components of tax expenditures and the tax gap.[3]

[3]Recent reports and testimony include Tax Administration: IRS' Efforts to Improve Corporate Compliance (GAO/GGD-92-81BR, April 17, 1992); Tax Policy: Puerto Rico and the Section 936 Tax Credit (GAO/GGD-93-109, June 8, 1993); and Earned Income Tax Credit: Effectiveness of Design and Administration (GAO/T-GGD-93-20, March 30, 1993).

Tax Accounts Receivable

Based upon the methods that we recommended in our May 1993 report on accounts receivable, IRS developed and reported an estimate of $21.6 billion for collectible receivables as of September 30, 1992. However, we were unable to audit this information because IRS only recently completed its analysis.

Historically, IRS reports have significantly overstated both its gross and net collectible accounts receivable. As of June 30, 1991, we estimated that gross receivables of $104.7 billion, representing about 96 percent of the reported balance, included $39.4 billion of invalid accounts, and that only $18.7 billion of the $65.3 billion of valid accounts were collectible. IRS had reported net receivables of $66.4 billion as of June 30, 1991, and, using a new methodology to estimate collectible accounts, $28.4 billion as of September 30, 1991. However, we found that the new methodology overstated collectible accounts receivable. This unreliable information on IRS' accounts receivable has affected decisions about the (1) impact of increased collections on the deficit, (2) evaluation of enforcement and collection performance, (3) determination of staffing levels, and (4) allocation of resources.

IRS gross receivables were overstated primarily because IRS included duplicate and insufficiently supported assessments that it had recorded as part of its efforts to identify and collect taxes due. These and many erroneous assessments were not valid receivables for financial reporting purposes and should not have been included in the reported balances. IRS' estimates of the collectibility of its receivables as of September 30, 1991, were unreliable because, in addition to including invalid receivables, IRS relied solely on collection experience and did not group assessments according to their collection risk or consider the taxpayer's current ability to pay.

Property and Equipment

Computer equipment and software, often referred to as automated data processing (ADP) assets, represent a significant portion of the cost of IRS' property and equipment. Because the information in its ADP inventory system could not be relied upon, IRS did not report a balance for property and equipment in its Principal Financial Statements. Instead, IRS reported, in the notes, a balance of $282 million, which included only a portion of its ADP assets based on a manually compiled listing of selected large-dollar ADP assets. In comparison, for the last three fiscal years, IRS had budgeted acquisitions of property and equipment totalling $453 million. IRS plans to continue to compile information about the cost of the remaining ADP assets. Planned expenditures for ADP assets, approaching $9 billion under IRS' Tax Systems Modernization effort, increase the importance of accurate ADP asset records to IRS.

IRS' ADP inventory records were unreliable for managing and reporting these assets because IRS had not instituted basic procedures and related controls to ensure that information in its ADP inventory system was current and accurate. Specifically, IRS (1) had not developed procedures to ensure that ADP acquisitions and disposals were accurately recorded on a timely basis, (2) did not effectively perform physical inventories, and (3) did not properly value ADP resources, primarily because, for many items, IRS used unrealistic estimates instead of actual costs. As a result of unreliable and incomplete records, IRS did not readily have the information it needed to effectively manage maintenance contracts, make ADP support staffing decisions, or support development of budget requests, procurement decisions, and performance measurement information related to the use of ADP assets. Further, IRS did not maintain records of the costs of in-house software development which, when combined with ADP inventory information, would provide more complete accountability for ADP costs and assist in planning decisions.

Management of Operating Funds

For years, IRS' systems used to process and account for spending of operating funds could not provide accurate and timely information needed to manage these funds. We were unable to audit approximately $4.3 billion or 64 percent of the reported spending of $6.7 billion from IRS' operating appropriations because IRS could not reconcile the total of detailed spending information in its outdated systems with summary amounts reported by such systems. Due to this limitation, we also were unable to adequately evaluate and test controls relating to these operating expenditures and the majority of operating accounts. The remaining $2.4 billion of reported spending in fiscal year 1992, which we audited, was processed by a new system installed in fiscal year 1992 in IRS' National Office and one region. This new system was implemented throughout IRS on October 1, 1992.

For the spending that we were able to audit, we found that IRS' systems and controls did not provide (1) a reasonable basis for determining compliance with laws governing the use of budget authority and (2) reasonable assurance that its disbursements were appropriate. To resolve some of these weaknesses, on October 1, 1992, IRS initiated additional functions in its new system which (1) provide up-to-date information needed to monitor available appropriations, including the introduction of quarterly spending limits, and (2) determine whether funds are available before they are obligated. We did not review the effectiveness of these changes during our audit. However, these changes were not designed to address weaknesses in other areas, which are described below.

There were significant delays in recording certain types of expenditures and adjustments against appropriation accounts. For example, we noted reconciling items and transactions in suspense accounts that were not being effectively investigated and resolved. These included several billions of dollars in cumulative gross differences between IRS' and Treasury's cash records, some of which may partially or wholly offset each other, that would result in adjustments to either Treasury's or IRS' records or both. IRS recently established a task force to resolve these cash differences. We also noted unliquidated obligations that were not being reviewed for appropriateness.

Also, transactions were inappropriately processed due to nonintegrated systems, inadequate review of supporting documents, and inadequate related processing guidance. Specifically, we found (1) duplicate, unsupported, and improperly timed disbursements to vendors and (2) inaccurate or no interest paid on late payments. For example, in a random sample of 280 payments, we found

- 32 duplicate and overpayments totalling $0.5 million, 4 of which were part of our sample and 28 that were discovered in related documentation;
- 112 payments totalling $17.2 million, for which complete supporting documentation could not be provided;
- 83 early payments, resulting in interest cost to the federal government, which did not have evidence of approval for early payment;
- 81 payments made after the due date, for which IRS was required to pay interest; and
- 56 of the late payments for which interest was not properly calculated or paid.

Because IRS did not have reliable information on the use of operating funds, its reports on operating appropriations, used by its managers, Treasury, OMB, and the Congress, also were unreliable. The reliability of historical data included in the President's annual budget submission to the Congress was further diminished because IRS used inappropriate assumptions in converting this data to categories prescribed by OMB.

Further, IRS' Statement of Budget and Actual Obligations, one of its Principal Financial Statements, included amounts that were based on categories used for internal management, rather than those categories reported in its budget submission and as required by OMB.

Computer Controls

To process and account for its revenues, IRS relies on extensive data processing operations, which should include overall or general controls to ensure that data are processed as authorized and are adequately protected from unauthorized change or disclosure. IRS did not adequately control access authority given to computer support personnel or adequately monitor employee accesses to taxpayer data. Further, controls did not provide reasonable assurance that only approved program versions were implemented. Weaknesses in computer controls, according to IRS, permitted employees to make unauthorized accesses and modifications to taxpayer information, resulting in unauthorized refunds. Such weaknesses also increased the risk of unintentional errors. Also, the computer capacity at the backup site for IRS' primary computing center is not adequate to run all of the primary and backup sites' critical applications at the same time, and IRS has not tested the effectiveness of its recently revised disaster recovery plan for the primary computing center.

IRS is in the process of implementing new systems to monitor employee activities relating to computerized taxpayer information, and it plans to obtain needed computer capacity at its backup site in 1994 and test its disaster recovery plan in 1993.

Seized Assets

We were unable to audit amounts reported for IRS' seized assets because IRS has not completed compiling its physical inventory of these assets as of September 30, 1992, and, therefore, could not provide us with detailed records that supported its reported balance of $797 million. However, we found that IRS had not instituted basic systems and controls to provide reasonable assurance that asset seizures and disposals were accurately recorded on a timely basis and that seized assets converted to IRS' use were properly controlled and reported. Other deficiencies related to seized assets are discussed in our testimony entitled Tax Administration: IRS' Management of Seized Assets (GAO/T-GGD-92-65, September 24, 1992).

FMFIA

IRS did not disclose the overall severity of its internal control and accounting system weaknesses in its fiscal year 1992 FMFIA report to

Treasury. Without adequate disclosure, users of the FMFIA report will not be aware of the extent of IRS' weaknesses and the efforts needed to correct them. We found material weaknesses that IRS either did not include or did not adequately disclose in its fiscal year 1992 FMFIA report. The severity of the weaknesses seriously impaired IRS' ability to safeguard, manage, and control its tax revenues and operating expenditures.

The review procedures used by IRS to conduct the FMFIA reviews were insufficient and the guidance and training provided FMFIA review staff were inadequate. In addition, some previously identified material weaknesses that IRS reported as corrected, including the above described weaknesses related to seized assets and manually computed interest on accounts receivable, still exist because IRS did not address the fundamental causes of those weaknesses or ensure that corrective actions were effective.

IRS reported its inability to accurately account for its ADP assets as a material weakness. However, other weaknesses were reported so broadly that they did not focus on all of the related issues. For example, while IRS broadly reported in its FMFIA report that the management of its delinquent debt needs to be improved, it did not disclose that its gross receivable balance was overstated. Further, in some instances, IRS did not disclose the full extent of the weaknesses. For example, IRS reported that vendors were not paid on time, but did not disclose the extent of the weaknesses in controls over payments that we identified. Also, IRS' reported weaknesses in ADP controls did not address all of the weaknesses we noted during our audit.

Financial Management at IRS

IRS' CFO, although responsible for compiling the Principal Financial Statements, did not have the authority needed to ensure that the financial management information and supporting data contained in IRS' computer systems was properly maintained and reported. While the CFO assumed an advisory role in system development efforts during 1992, the CFO's approval of related plans and implementation efforts was not required. Additionally, the CFO did not have authority over the operation of certain functions, such as accounting for revenue and for property and equipment, which are necessary for proper performance of the CFO's duties. IRS plans to restructure the duties of the CFO to be more consistent with these responsibilities.

Objectives, Scope, and Methodology

Management has the responsibility for

- preparing the Principal Financial Statements in conformity with applicable accounting principles,
- establishing and maintaining internal controls and systems to provide reasonable assurance that the broad control objectives of FMFIA are met, and
- complying with applicable laws and regulations.

In undertaking our audit of IRS, we planned to conduct an audit of its Principal Financial Statements and of internal controls over safeguarding of assets, assuring material compliance with budget authority and with laws and regulations we considered relevant, and assuring that there were no material misstatements in the Principal Financial Statements. We also planned to test IRS' compliance with laws and regulations we considered relevant. But we did not plan to evaluate all internal controls relevant to operating objectives as broadly defined in FMFIA. For the reasons set forth earlier in this report, we were unable to complete the planned audit work.

As noted above, we were unable to obtain reasonable assurance about whether the Principal Financial Statements are reliable (free of material misstatement and presented fairly in conformity with applicable accounting principles). We were able to evaluate certain internal controls in the following areas; however, due to limitations on the scope of our work, all material weaknesses may not have been detected in these areas:

- cash receipts,
- refund payments,
- tax accounts receivable,
- property and equipment,
- Treasury funds,
- computer general controls, and
- seized assets.

We also obtained an understanding of internal controls over the reliability of performance measures reported in the Overview and Supplemental sections of IRS' report and assessed whether information in the Overview and Supplemental sections was materially consistent with the information in the Principal Financial Statements.

We tested compliance with selected provisions of the following laws and regulations:

- Chief Financial Officers Act of 1990 (Public Law 101-576);
- Federal Managers' Financial Integrity Act of 1982 (Public Law 97-255);
- National Defense Authorization Act for Fiscal Year 1991 (Public Law 101-510); and
- certain laws relating to distribution of excise taxes (26 U.S.C. 9501-9510).

We could not adequately test compliance with the Prompt Payment Act (31 U.S.C. 3901-3907) or with many laws we considered necessary to test because of the previously noted ineffective internal controls and limitations on the scope of our audit. As noted above, the limited tests we were able to perform would not necessarily detect material instances of noncompliance had they occurred.

Except for the limitations on the scope of our work described in this report, our work was done in accordance with generally accepted government auditing standards and OMB Bulletin 93-06, "Audit Requirements for Federal Financial Statements."

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

May 28, 1993

Financial Statements

The Department of the Treasury
•
Internal Revenue Service

Internal Revenue Service

Chief Financial Officer
Annual Report

•

Fiscal Year 1992

Overview to the Financial Statements

Internal Revenue Service

Overview to the Financial Statements for the Fiscal Year Ended September 30, 1992

INTRODUCTION

Size and Scope of Operations

In many respects the Internal Revenue Service can be thought of as a multi-billion dollar, highly decentralized and complex corporation. Many people are unaware of the size and scope of the Service's operations as the nation's tax collector, but the numbers are impressive. In FY 1992, IRS operations --

- processed **204 million** tax returns, of which approximately **115 million** (56%) were filed by individual taxpayers.
- processed over **1 billion** information documents (primarily Forms W-2 and 1099).
- received **11 million** returns filed electronically.
- handled **1.7 billion** pieces of paper.
- collected **$1.12 trillion.**
- issued **89 million** refunds totalling **$113 billion.**
- assisted more than **79 million** taxpayers, and
- maintained over **600** offices to serve taxpayers.

To handle operations of this magnitude, the Service managed a budget of $6.7 billion, of which $4.6 billion was spent on salaries and benefits for our employees. We employed nearly 115,000 people worldwide; however, during the peak filing season, that figure jumped to over 130,000. In addition, we continued to invest in our information systems, as evidenced by expenditures of $974 million, including $282 million for initiatives related to our Tax Systems Modernization effort.

These numbers all add up to BIG! Compared to the Fortune 500 companies, in 1991 (the most recent year for which statistics are available) we would have ranked first in total sales (revenue), ahead of General Motors, and twelfth in number of employees, ahead of such industry giants as Westinghouse, Xerox and McDonnell Douglas.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Year Ended September 30, 1992

Historical note:

The first IRS Commissioner's Annual Report in 1863 listed 4,000 employees and $41 million in revenue receipts collected from September 1, 1862 to June 30, 1863. In fiscal year 1992, revenue receipts totaled $1.12 trillion and IRS had nearly 115,000 employees.

Highlights of 1992 Operations

The numbers alone don't tell the whole story. Our 1992 operations showed significant progress in many areas. We are very proud that the Ogden Service Center became the first civilian agency to receive the Presidential Award for Quality. This award, the public sector equivalent of the Malcolm Baldridge Award, is given in recognition of outstanding work quality and customer service.

We streamlined our procedures for installment agreements and offers in compromise of tax debts to make these collection tools more accessible and truly viable alternatives for taxpayers who need assistance in meeting their tax obligations. We prepared to bring millions of nonfilers back into the tax system using our nonfiler program strategy which involves all parts of the Service. This strategy combines outreach and assistance for those who need help and reserves enforcement for those who will comply in no other way.

We successfully built momentum for a reduction in the burden of tax administration through efforts such as revamping complex rules for the payroll tax deposit system. Additionally, the telephone tax filing program, Telefile, was such a success during its testing that we are offering this method of filing taxes to a larger taxpayer population.

We began development of a Cost Management System that will enable managers to support their decisions on how best to use resources and improve operations with knowledge and awareness of what it costs them to do business. Our Tax Systems Modernization effort–a fundamental strategy for redesigning tax administration–made major strides with several successful contract awards.

Sometimes developments like these are not easily communicated in financial statements and performance indicators and their importance may be overlooked. But these and other initiatives should be noted because they demonstrate how we are striving toward our Strategic Objectives of Increasing Voluntary Compliance, Reducing Taxpayer Burden, and Improving Customer Satisfaction and Quality-Driven Productivity.

INTERNAL REVENUE SERVICE
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The CFO Act of 1990

We also made significant gains in enhancing financial management in the Internal Revenue Service with the implementation of the Chief Financial Officers (CFO) Act of 1990. The CFO Act represents the most far-reaching financial legislation in nearly 40 years. The IRS is one of the agencies designated by the Act as a pilot for preparing comprehensive financial statements on all funds and having them audited. We fully realize the need for greater management attention to financial management and recognize the extent of our problems, which we have begun to address.

In recognition of the need to be held accountable to our stakeholders and the requirements of the CFO Act, we have prepared the accompanying comprehensive financial statements, with notes, covering fiscal year 1992. The financial statements are intended to be of value to users in making economic, social and political decisions, and in assessing our accountability. They are being audited by the U.S. General Accounting Office. In preparing the formats and note content, professional guidance was obtained from a variety of sources.

The Government Accounting Standards Board (Concept Statement No. 1) states that: "Governmental accountability is based on the belief that the taxpayer has a right to know, a right to receive openly declared facts that may lead to public debate by taxpayers and their elected representatives." Accountability includes a requirement to render an account or explain one's actions to someone else who has the authority to assess performance and to make judgement and take action.

The impact of the audit on our organization, however, goes beyond the finance function. We have begun to look carefully at the underlying financial support throughout the organization. Using audit findings to complement already existing cost-benefit analyses, we are now starting to integrate financial management decisions with decisions regarding our operations (processing tax returns).

Limitations of the Financial Statements

The financial statements have been prepared to report the financial position and results of operations of the Internal Revenue Service, pursuant to the requirements of the CFO Act.

While the statements generally have been prepared from the books and records of the IRS in accordance with the formats prescribed by OMB, they are different from the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The statements should be read with the realization that they are for a component of a sovereign entity (the United States Government), that unfunded liabilities reported in the financial statements cannot be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Year Ended September 30, 1992

DESCRIPTION OF THE ORGANIZATION

The operations, organization, and locations of the Internal Revenue Service are all organized around the most efficient and effective structure to accomplish our Mission.

MISSION STATEMENT

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

Who Are We?

The Office of Commissioner of the Internal Revenue was established by act of Congress on July 1, 1862 to assess, levy and collect taxes and to enforce the tax laws through seizure and prosecution. At that time, the revenue was derived primarily from customs duties and taxes on shipping and importations. Congress first received authority to levy taxes on income in 1913 with the passage of the 16th amendment to the U.S. Constitution. Since that time, the nation has depended on the employees of the IRS to collect the necessary monies so that the Federal government can continue to defend, maintain and improve the well-being of our citizens.

In 1952, the Bureau of Internal Revenue was reorganized by Congress and subsequently became known as it is currently titled, the Internal Revenue Service. We are responsible for administering the Internal Revenue Code and related statutes and ensuring compliance with the tax laws, except those relating to alcohol, tobacco, firearms and explosives.

Our Structure

The Internal Revenue Service is headed by the Commissioner who reports to the Secretary of the Treasury. It is the largest bureau of the Department of the Treasury, employing nearly 115,000 people worldwide. We have offices in every major city in the U.S., in U.S. territories, and in 13 international cities. Our organization is designed to allow for maximum decentralization, while providing for uniform interpretation and enforcement of the tax laws and efficient utilization of resources. There are three organizational levels: the National Office, the Regional Offices, and the District Offices and Service Centers.

The National Office, located in Washington, D.C., is the headquarters for IRS. It is responsible for developing nationwide policies and programs for the

INTERNAL REVENUE SERVICE
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for the Fiscal Year Ended September 30, 1992

administration of the Internal Revenue Code and provides direction to the field organization. The National Office includes the offices of the Commissioner, Deputy Commissioner, Chief Financial Officer, Chief Information Officer, Chief Operations Officer, and the Assistant Commissioners, who are the functional heads for our collection, criminal investigation, employee plans and exempt organizations, examination, finance, human resources, information systems development, information systems management, international, planning and research, procurement, returns processing, and taxpayer services activities. It also includes the offices of the Chief Counsel and Chief Inspector.

The Martinsburg Computing Center, located in Martinsburg, West Virginia, maintains the master files of individual and business tax accounts. The Detroit Computing Center, in Detroit, Michigan, provides various data processing services for the IRS and other Federal agencies.

There are seven Regional Offices, each headed by a Regional Commissioner who is responsible for supervising and evaluating the operations of the District Offices and Service Centers within his/her region. Regional Offices are located in Atlanta, Chicago, Cincinnati, Dallas, New York City, Philadelphia, and San Francisco.

There are 63 District Offices, at least one in each state, that are responsible for providing assistance and service to taxpayers, determining tax liability by examination of tax returns, determining pension plan qualifications, collecting delinquent returns and taxes, and investigating criminal and civil violations of the tax laws.

There are 10 Service Centers which process the millions of tax returns, refunds and related documents through highly automated data processing systems. In addition, the Service Centers maintain accountability records for taxes collected and provide support to the District Offices in the areas of compliance and taxpayer services.

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RESULTS OF OPERATIONS

To improve our overall accountability, facilitate making decisions that cut across organizational lines, and provide stronger emphasis to customer service, the Service constantly looks for better ways of doing business. A major challenge confronting us is how to focus our energy and limited resources on the most important opportunities. If we are to focus properly, it is critical to understand that "important" is determined by our customers, the taxpayers.

Core Business Systems

During FY 1992, we embarked on a systems approach to managing which we believe holds great promise: Core Business Systems. Managing within a systems approach will provide the focus for our efforts that we have been seeking. The concept of "Core Business Systems" aids us in creating this focus and in aligning our improvement efforts toward taxpayers. It helps us to break down the walls between functions and look at the Service from a process, rather than a functional or task, perspective. This is an effective business approach which has proven successful in private industry. It will also help us better evaluate the results of our operations.

A core system is a series of steps and processes which, when viewed through a horizontal slice across the many functions of IRS, are all integrally important to providing products or services to customers who value them. Core Business Systems uses a top-down approach for identifying, analyzing, and improving major cross-functional Servicewide business systems.

We identified five Core Business Systems that encompass all the activities of the IRS. These core systems support, and are defined by, the Mission Statement:

- **Value Tracking** -- finding out what taxpayers value in the tax administration system.
- **Ensuring Compliance** -- ensuring that taxpayers are complying with requirements of the tax administration system.
- **Informing, Educating and Assisting** -- providing information and assistance to taxpayers to facilitate voluntary compliance with the law and understanding of the tax administration system.
- **Managing Accounts** -- processing routine transactions and providing account and revenue information which is accessible to all authorized customers.
- **Resourcing** -- providing the human, technological, physical, and financial resources to support the tax administration system.

INTERNAL REVENUE SERVICE
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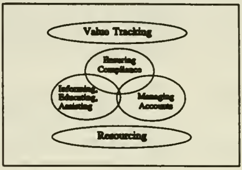
The graphic below depicts the interrelationships of these Core Business Systems:



Performance Measurement

Performance measurement is the hallmark in evaluating the results of operations in a non-profit environment. The "bottom line" for a government organization is, obviously, not profit or loss, but rather the success or failure in accomplishing a mission or delivering a program. Performance measurement, then, is geared to the functions, activities and programs that an organization uses to accomplish its mission or purpose.

The Service measures its performance against the objectives set forth for each of the functions or activities contained in the Core Business Systems. We have used output-related performance measures and other statistics as management tools for many years, mostly to measure the flow of tax returns and related actions (refunds, corrections, assessments, etc.) through the organization. In recent years, we have started adding other factors--qualitative, productivity, and financial--to these measures to produce outcome indicators. These new indicators give us a more complete picture of our performance and help us to better assess our progress in meeting the corporate objectives of increasing voluntary compliance, reducing the burden on taxpayers, and improving customer satisfaction and productivity.

Following are representative performance indicators for each of the Core Business Systems and a discussion of the progress made on each. It is important to note that these 15 indicators are part of a larger body of over 100 used within the Service on a regular basis.

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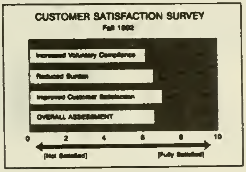
Value Tracking

The objective of the Value Tracking Core Business System is to determine, communicate, and track the extent to which taxpayers value our products and services and to discover new product and service opportunities that will further the IRS Mission. This system applies the concept of net customer value to IRS Core Business Systems. It encompasses the Service's activity related to obtaining information and feedback from taxpayers and building customer value concepts into IRS operating systems and measurements. IRS organizations are the primary internal customer of this Core Business System, with taxpayers and stakeholders regarded as external customers.

Performance Indicator

The performance indicators for the Value Tracking Core Business System are the results of surveys of the U.S. adult population conducted in the spring and fall of 1992. We contracted with a private sector company to conduct these surveys in order to determine how well we are meeting our customers' needs and to aid us in planning future improvements.

Customers were asked to rate the IRS on a scale from one to ten in the following areas: (1) Increased Voluntary Compliance; (2) Reduced Burden; (3) Improved Customer Satisfaction; and (4) Overall Assessment. Through these surveys we determined that the public rates the IRS 6.5, on a 10-point scale, on overall performance. One-third of the respondents gave us an 8, 9, or 10 rating. The results of the survey are shown in the next graphic. There was no statistical difference between the two reporting periods, therefore only the results of the Fall 1992 survey are displayed.



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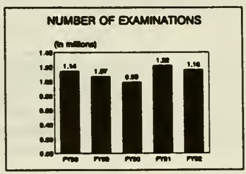
Ensuring Compliance

The objective of the Ensuring Compliance Core Business System is to preserve the integrity of the voluntary tax system by continually measuring compliance behavior, identifying and determining root causes of non-compliance, and taking actions to improve compliance. The system begins with measuring compliance and ends when compliance is confirmed. The programs for this Core Business System are heavily impacted by the philosophies contained in our corporate objectives to increase voluntary compliance and to reduce taxpayer burden.

Performance Indicators

1. Number of Examinations and Contacts

The number of examinations and contacts is an output measure which demonstrates the level of civil enforcement we use in ensuring compliance and is focused primarily on the rate of success we experience in increasing voluntary compliance. The number of examinations and contacts includes the sum of all completed examinations of taxpayer returns and all completed contacts, excluding international examinations, Information Return Program (IRP) notices, excise, employment, and Windfall Profit examinations. Examinations include individual, corporate, fiduciary, partnership, estate, and gift tax return examinations conducted by tax auditors and revenue agents at District Offices and tax examiners in the Service Centers. Contacts are generally made to handle corrections and non-IRP matching investigations conducted by tax examiners in the Service Centers.



During FY 1992, we completed 1.16 million examinations, representing a decrease of 4.9% from FY 1991. The number of contacts during FY 1992 represents a decrease of 10.5% from FY 1991 and 23% from FY 1988. The

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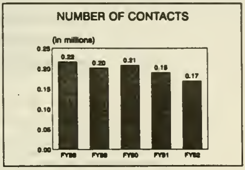
reduction in examinations and contacts was largely caused by a reduction of some 250 tax examiner staff years in our Service Centers. This is an indication of our cost effective allocation of resources to ensure compliance.



Examinations and contacts continue to be an IRS enforcement mainstay, and a reduction in these would seem to be alarming; however, the tax world has changed dramatically in recent years. We receive from third parties--employers, state tax agencies, and financial institutions--information documents that report income earned, mortgage interest, other interest and dividends, capital gains, and contract fees. There has been a steady increase in the number of information reporting documents we receive and a steady improvement in our ability to match this information electronically against tax returns filed by individuals. This automated information reporting program now covers 90 percent of all income reported by individuals and between 40 and 50 percent of the deductions claimed. It is a critically important supplement to traditional, one-on-one examinations and contacts, and helps to explain how examinations and contacts can decrease while overall audit coverage actually increases.

2. Audit Cycle Time

Audit Cycle Time is defined by the average time elapsed between the start of an audit and when the case is closed by the Examination Division. It includes the average days to complete audits and contacts in the Service Centers by tax examiners, audits of individual returns by tax auditors, and audits of individual and corporate returns by revenue agents in the District Offices. Audit Cycle Time is an efficiency measure of our efforts to ensure compliance and an effectiveness measure of taxpayer burden reduction because the period of time a taxpayer is under audit is burdensome and stressful to the taxpayer.

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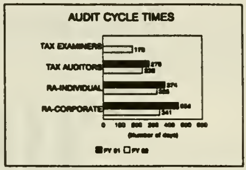
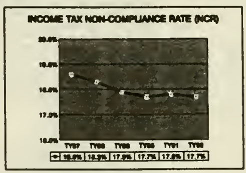


Except for tax examiners, this indicator has been tracked and reported for the last two fiscal years. We have successfully reduced the burden we place on the taxpayer in this area. We report performance in the following categories: Tax Examiners; Tax Auditors; Revenue Agents-Individual; and Revenue Agents-Corporate.

3. Income Tax Non-Compliance Rate



The Income Tax Non-Compliance Rate (NCR) is defined as the percentage of total tax liability for a tax year that is not paid voluntarily. The NCR is one indicator used in the Core Business System "Ensuring Compliance", and is a key

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element in measuring the effectiveness of some of our compliance initiatives. Other applications of this rate will allow the IRS to identify and target noncompliant market segments, thereby ensuring the effective allocation of resources and highest rate of return. We are working toward reducing the level of noncompliance by ten percentage points by the year 2000.

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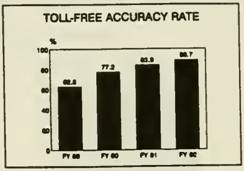
Informing, Educating and Assisting

The objective of the Informing, Educating, and Assisting Core Business System is to enable taxpayers to comply with the tax laws by providing correct, timely and useable information and assistance to all who need it to facilitate not only compliance with the appropriate tax law, but an understanding of the tax system as well. The system begins with the formulation of tax law and/or policy and ends when taxpayers/customers know how, when, why and where to meet the requirements of the tax system. How the IRS implements the initiatives under this Core Business System will have a direct impact on reducing taxpayer burden, increasing voluntary compliance and improving productivity.

Performance Indicators

1. Toll-Free Accuracy Rate

The Toll-Free Accuracy Rate is the percentage of correct responses by Taxpayer Service staff to test inquiries on technical tax law and procedural matters, as measured by the Integrated Test Call Survey System (ITCSS). This indicator measures the efficiency of a major service for customers that contributes to reducing burden and increasing voluntary compliance.



In 1992, the cumulative accuracy rate for toll-free telephone responses regarding tax law, as measured by the ITCSS, was 88.7%, which exceeded our goal of 85%. Questions regarding IRS procedures are also answered, but the accuracy of that information will not be tracked by the ITCSS until FY 1993. In addition to toll-free telephone assistance, we also provided pre-recorded information over toll-free lines on 140 topics. This information is available 7 days a week, 24 hours a day. Almost 68 million calls came in through the two systems in 1992.

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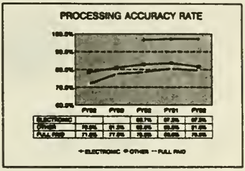
2. Processing Accuracy Rate

How accurately we process the tax return data that the customer supplies to us impacts primarily on our objective of reducing the taxpayer's burden. Due to varying levels of complexity, we track and report accuracy rates for two types of returns: "other than full paid" and "full paid". "Other than full paid" include returns where the taxpayer is either due a refund from the IRS or the taxpayer has not paid 100% of their tax liability. In addition, "other than full paid" consist of 1040EZ's, 1040A's, or 1040's with no additional schedules attached, and are thus easier to process. "Full paid" are those returns where the taxpayer is not due a refund and/or has paid 100% of their tax liability.



For the last five years, our processing accuracy rate for "other than full paid" returns has been consistently higher than the accuracy rate for "full paid" returns. The accuracy rate of processing "other than full paid" returns has improved from 78.5% in FY 1988 to 81.6% during FY 1992. Our accuracy rate for "full paid" returns has improved by almost eight percentage points over the same time period (71.8% in FY 1988 to 79.5% in FY 1992). Because "full paid" returns are typically more complex (e.g., additional schedules attached to the 1040), there is a higher error rate.

Errors are caused by both the taxpayer and by our employees. However, there is currently no method available for distinguishing the two for reporting purposes. We will attempt to eliminate taxpayer errors by providing additional education and assistance before they file their respective returns, and eliminate employee errors through improved training, technology, and quality programming. Tax form simplification is another initiative on which we are continuously working.

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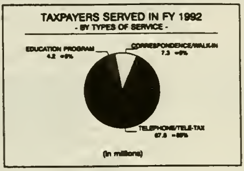
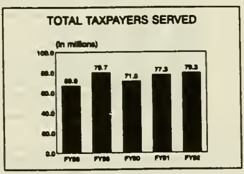
3. Total Taxpayers Served

Taxpayer service is provided in three areas: (1) telephone calls answered (toll-free, non toll-free, and tele-tax calls answered); (2) walk-ins and correspondence (taxpayers visiting IRS offices and correspondence written in response to taxpayer's letters); and (3) taxpayers assisted through IRS education programs, as shown in the following graphic.





Every year we make special outreach efforts to provide taxpayers with information and training to help them file their returns. We served over 79 million taxpayers in FY 1992, as shown in the above graphic, clearly

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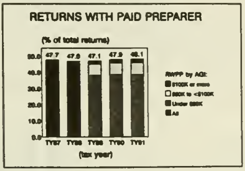
demonstrating our commitment in becoming a customer service organization. During the 1992 filing season, we gave presentations on the Earned Income Credit and other topics, and also conducted Small Business Education Workshops to inform businesses of their tax responsibilities, particularly as they pertained to federal tax deposits, record keeping, and employment taxes. Additionally, during the 1992 filing season, more than three million low income, elderly and non-English speaking taxpayers received help filing their tax returns from 79,000 volunteers in the Volunteer Income Tax Assistance (VITA) Program and Tax Counseling for the Elderly (TCE) Program.

4. Returns with Paid Preparer

The percentage of individual returns filed (Form 1040 series) with paid preparer is a good indication of the complexity of tax laws, tax forms, and the instructions we give to the 'average' taxpayer. This performance indicator is a good measure of the amount of burden we place on the taxpayer.



The trend from 1987 to 1991 shows that slightly more taxpayers are turning to paid preparers for assistance in completing their tax returns. In 1991, over 48% of individual returns were filed with a paid preparer, or some 55.7 million individual tax returns. Analysis of the composition of the data can indicate what income levels are being most affected and what factors contributed to the cause. For example, in 1989, 1990 and 1991 (the only years for which data is currently available) slightly more than 80% of the returns filed with paid preparers were for taxpayers with less than $50,000 of Adjusted Gross Income. Knowing how different groups of taxpayers are burdened helps us direct outreach and assistance efforts, design tax forms (the 1040EZ form was designed to reduce the burden on a specific group of taxpayer) and develop appropriate regulations.

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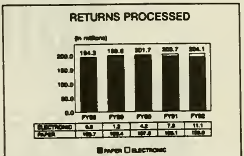
Managing Accounts The objective of the Managing Accounts Core Business System is to process routine transactions and provide for the creation, maintenance and security of accurate account and revenue information which is accessible to all authorized customers. The system begins with customers supplying tax returns, information documents and payments, and ends when customers no longer have use for the information. The programs for this Core Business System are largely Service Center oriented, dealing mainly with the processing of tax returns through the "pipeline" of the Service Center.

Performance Indicators

1. Returns Processed

The number of tax returns filed with our Service Centers is a measure of a major process relative to the accomplishment of our mission. "Returns processed" includes both paper and electronic returns, and "paper returns" includes supplemental returns (amended returns and extensions for both 1040's and 1120's). During FY 1992, we processed 204.1 million tax returns, an increase of .2% over FY 1991 and an increase of 5% or 9.8 million returns over the last five years. Of the total tax returns processed in FY 1992, 56% or 115 million were individual returns and the remaining 44% were corporate, partnership, excise tax, employee plans and exempt organizations, various types of employment tax, and estate and gift tax returns.



Currently, five of the ten Service Centers process electronically filed tax returns (ELF), while all Service Centers process a wide variety of paper returns. The ELF program allows taxpayers to provide tax return information to a third party processor, usually a tax return preparer, who transmits the information to the IRS

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through a computer linkage. During FY 1992, 11.1 million or 5.3% of all returns filed with the IRS were ELF returns. The chart also shows that we have turned the corner on processing of paper tax returns. Since 1989, the second year of the ELF program, the number of paper returns filed has decreased while total returns have increased due to the increase in ELF returns.

The error rate for ELF returns is 2% (compared to 15% for paper returns), and refunds are received within 2-3 weeks (compared to 6 or more weeks for paper returns). This means less burden on taxpayers because they have fewer problems caused by errors on their return and greater customer satisfaction because they get their refunds faster. It also means cost savings for IRS because of the lower error rate. For the 1992 filing season, we accepted ELF balance-due returns for the first time in a fully operational mode. We project that over 20 million taxpayers will file electronically by 1994.

2. Processing Cycle Time (Refunds and Adjustments)

The amount of elapsed time between the receipt of the return and the refund issue date defines processing cycle time for refund timeliness. The amount of elapsed time between the initiation of the adjustment and the closing of the case by the tax examiner defines processing cycle time for adjustment timeliness.

Because the length of the processing cycle time has an impact on reducing the burden on the taxpayer, the IRS strives to keep the processing cycle time to a minimum. During FY 1992, the average days from receipt of a return (both individual and business) in the mail room to the date a refund check was issued was 37 days. The refund baseline is 40 days. The average time from initiation of an adjustment to the time the case was closed by the tax examiner was 31 days for FY 1992.

We are also improving the timeliness, quality and consistency of correspondence processing. Our goal is to close 65% of all correspondence cases within 30 days from the date the case is initiated, and if a final response is not sent to a taxpayer within 30 days, an interim letter explains the reason for the delay. This letter also provides an expected final response date and an IRS contact person and telephone number so the taxpayer can call for additional information. Accurate and timely handling of correspondence will reduce case rework and repeats, thereby reducing the burden of taxpayers having to make additional inquiries, and will reduce the burden on taxpayers of dealing with additional notices.

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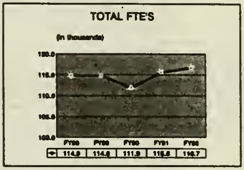
Resourcing

The objective of the Resourcing Core Business System is to timely obtain, develop and maintain quality human, technological, physical, and financial resources which enables the Service to provide the best customer value. The focus of this core system begins with the identification of current and future customer needs and ends when the customer is satisfied with the value provided.

Performance Indicators

1. Total Full Time Equivalents (FTE's)



Total FTE's, or staff years, indicates the level of staffing that goes along with total budgeted operating costs shown below. When considered with other performance indicators, it is a good macro-level indicator of the level of productivity the Service is achieving in accomplishing its mission. These are direct FTE's and do not include any reimbursables or overtime. Over the past five years, the level of staffing has been relatively constant. For FY 1992, we realized 116,673 direct FTE's, an increase of 0.90% over FY 1991. From FY 1988 to FY 1992, the increase is 1.6% or 1,800 FTE's.

2. Total Operating Costs

Total budgeted operating costs are the current year appropriations available to expend on the salaries, goods and services necessary to accomplish our activities for the current year. Our operating costs have increased by 30.6% ($1.6 billion) from FY 1988 to FY 1992; however, much of this increase is attributable to mandatory pay increases and to investments in modernization (Tax Systems Modernization alone accounts for approximately 31% of the $1.6 billion increase).

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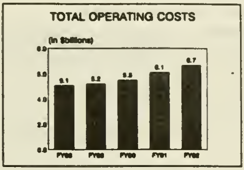
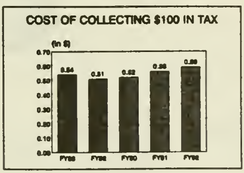


3. Total Tax Collected Compared to Total Operating Costs

This is a traditional macro-level indicator we use to measure our overall mission accomplishment. While budgeted operating costs have increased since FY 1988 by some 30.6%, collections have increased by only 20.5% ($191.8 billion) over the same period of time. This has increased our cost of collecting $100 from $0.54 in FY 1988 to $0.59 in FY 1992, an increase of 9.3%. We believe that this increase is exacerbated by the recent recession and difficult economic times. We are also building for the future through capital investments in Tax Systems Modernization that will benefit the Service and taxpayers into the next century.



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RESULTS OF FINANCIAL MANAGEMENT

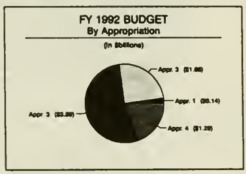
FY 1992 Budget

The Service received an operating budget of $6.68 billion for FY 1992, which includes the *Hurricane Andrew Relief Fund* authorized by Congress late in the fiscal year. In addition, funding for other purposes (non-operating) was provided, as explained later in the Overview.

The Service's operating budget consists of the following four Congressional appropriations:

#1 - Administrative and Management Appropriation.
#2 - Processing Tax Returns and Assistance Appropriation.
#3 - Tax Law Enforcement Appropriation.
#4 - Information Systems Appropriation.

The dollars associated with these appropriations are shown in following graphic. The funds allocated for the Tax Systems Modernization effort, $296.8 million, are included in Appropriation 4.



Tax Systems Modernization (TSM)

Tax Systems Modernization is not just a matter of automating manual processes, but rather embracing technology to leverage change throughout the organization. TSM involves changing the way we do business, changing the way we interact with our customers, and improving the efficiency of our operations. Restructuring the business of IRS with the support of technology will allow us to significantly reduce taxpayer burden, improve voluntary compliance, achieve quality-driven productivity gains and increase revenue.

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TSM is well under way and already producing measurable benefits. Taxpayers are receiving faster and more accurate service, tax account issues are resolved more efficiently, and IRS case workers have improved access to information needed to perform daily tasks. Electronic filing and TeleFile provide alternative ways to file tax returns. We can now control and associate taxpayer correspondence so that timely IRS responses address all issues raised by the taxpayer and IRS. New business concepts like Compliance 2000 and one-stop service enable us to tailor up-front education and assistance to market segments and provide better service on the back-end as well. The section on Supplemental Financial and Management Information in this report includes a detailed discussion of TSM initiatives and associated expenditures during fiscal year 1992.

Automated Financial System (AFS) For several years, IRS has been working towards a single integrated financial management system as required by OMB Circular A-127. The new system, called the Automated Financial System (AFS), is an off-the-shelf software product called Federal Financial System and includes modifications specified by the Service. AFS will provide a fully integrated budget and accounting process, including general ledger (the Standard General Ledger is incorporated), budget execution, planning, accounts receivable, disbursements, accounts payable, document tracking, purchasing, travel, and project cost accounting. Features include daily updates of accounting and budget information, commitment accounting, increased online query, online status of funds, and funds control. The system will also interface with the payroll system, Travel Reimbursement and Accounting System (TRAS), Program for Relocation Information and Moving Expenses (PRIME), and the Procurement Network (PRONET). The integration of AFS is planned to be completed by December 1996.

The AFS software is installed on computers in the Detroit Computing Center. The accounting module was implemented in Central Region during FY 1991, in the National Office in FY 1992, and in all remaining offices on October 1, 1992. The budget execution module was implemented in all offices on October 1, 1992. Full implementation of this system is a major step toward improving financial management within the Service because it will enhance the Service's ability to provide timely and accurate financial data for both internal and external users.

Cost Management The IRS is developing a Cost Management System that will enable managers to support their decisions on how to best use resources and improve operations with knowledge and awareness of what it costs to do business. This system is centered on the principles of activity-based management (ABM), and will be integrated with the existing AFS accounting/budgeting system, TIMIS-PC TARE timekeeping system, and existing operational workload management systems. In the private sector, this method is used to help businesses focus internally and determine whether their methods of doing business are the "best" ways. ABM concentrates on managing activities without organizational boundaries, versus the

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traditional vertical approach of managing by function and organization. An activity-based (horizontal) view focuses on a product/process orientation as the method to improve the value of the services provided to customers by maximizing operational efficiency and effectiveness.

The Cost Management System being developed builds on historical cost data by integrating workload, performance measurement, and financial data to improve products and processes. This ultimately provides value-added quality, and cycle time analysis that external and internal customers demand. The framework of the system represents an exciting change to the traditional finance paradigm.

The Cost Management System prototype is being conducted in the Cincinnati Service Center and will be expanded to the Seattle, Baltimore and Boston offices during FY 1993. The design is scheduled for completion in September 1994, with a two-year Servicewide implementation beginning in December 1994. Implementation of the system will help drive changes within IRS needed to meet the three Strategic Objectives: increasing voluntary compliance, reducing taxpayer burden, and improving quality-driven productivity and customer satisfaction.

Accounts Receivable

The growth of accounts receivable has been a concern since the mid-1980s. Reasons for the continued growth include growth in returns filed, the economy and inflation, increases in bankruptcy and litigation cases, improved examination document matching and substitute for return programs, the extended collection statute and declining enforcement staffing levels. Collections against receivables, however, have remained relatively constant over the last five years.

The Office of Management and Budget indicated in the FY 1992 President's Budget that the IRS accounts receivable collection program was a high risk area and expressed reservation about the adequacy of the program's progress and plans. Because of the enormous size and complexity of tax receivables, this area has been the focus of efforts to introduce new accounting principles, practices and systems wherever appropriate.

There are several major issues with tax receivables and the allowance for doubtful accounts that the Service is working to resolve. These were recently highlighted in the GAO report on their audit of tax receivables at June 30, 1991. At the date of their audit work, GAO found systems deficiencies and other inherent problems that overstated net tax receivables at June 30, 1991, and would adversely impact the FY 1992 statements if left uncorrected. At GAO's suggestion, IRS valued the reported collectibility of receivables by examining a sample of 2,600 accounts. We have also made progress in correcting the other deficiencies noted in the report.

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We will continue to aggressively address accounts receivable. Our projections, however, indicate accounts receivable will continue to grow, albeit at a reduced rate. We believe that our present initiatives, coupled with significant growth in resources dedicated to the prevention and collection of delinquent accounts receivable, are essential components of an effective strategy for collecting monies owed to the Federal government.

Prompt Payment

The Prompt Payment Act is a legislative directive for sound financial management. It directs federal agencies to pay invoices on time, to pay interest penalties when payments are late and to take discounts only when payments are made within the discount period. In FY 1992, we paid $673,000 in interest on 17,000 late payments (5%) out of 350,000 subject to the Prompt Payment Act.

We have taken several steps to improve on our payment processes and greatly reduce late payments. Conversion to AFS will improve the Service's performance by warehousing invoices to ensure timely payment. Also, the accuracy of this performance measurement will be improved by the inclusion of actual data rather than estimates derived from statistical sampling. The Controller appealed to field and National Office executives to be more diligent in following the guidelines for prompt payment of invoices, and follows up weekly to evaluate progress in this area. He also set up a Prompt Pay Task Force to study the various payment processes used by the Service to identify procedures and mechanisms that need to be added, streamlined, or eliminated. Correction of our prompt payment problems is a high priority for senior level managers in IRS.

Interpretation of Financial Statements

The following analysis seeks to impart to the reader a high level understanding of the reporting environment of the Service. In addition, this discussion seeks to assist the reader in interpreting the financial statements and footnotes.

Assets

Asset classes should be viewed as falling into one of two broad asset categories. The first category of assets relates to resources which are managed on behalf of the government. These resources are not available for use in internal operations of the Service. Essentially, these resources relate directly to the collection aspect of the Service. Currently, this category is comprised of Federal tax receivables, funds with the Treasury available for the payment of tax refunds, seized property and monies and revolving fund assets. These assets are designated as *Custodial Assets* in the Statement of Financial Position. The fiscal year 1992 financial statements report approximately $23.2 billion of custodial assets, composed primarily of federal tax receivables.

The second broad category of assets relates to those resources more commonly appearing in the statements of other federal entities. These resources do not relate directly to the collection effort as do Custodial Assets. These assets are referred to as *Operating Assets*. As of September 30, 1992 approximately $1.4 billion of

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operating assets were reported, comprised primarily of funds with U.S. Treasury, and receivables from other federal entities.

Operating assets are further categorized on the statement of financial position as "financial resources" or "non-financial resources". All operating assets, with the exception of inventory are classified as financial resources.

Liabilities

As with assets, liabilities are also divided into custodial and operating categories on the statement of financial position. It is easy to conceptualize custodial liabilities if one thinks of these liabilities as offsetting many of the custodial assets. For example, the tax receivable asset is offset by a liability (due to U.S. Treasury, tax receivables) thus designating that the receivable is "due to" the Treasury upon collection. Seized properties and monies are also offset by a corresponding custodial liability.

As with operating assets, operating liabilities relate to the non-collection aspect of the Service. Operating liabilities are comprised of payables, accrued payroll and benefits and liabilities for deposit funds. In addition, unfunded liabilities for annual leave and contingencies are included.

Net Position

Net Position sections on the Statement of Financial Position reflect the difference between assets and liabilities. This section corresponds roughly to the equity section of conventional balance sheets, as it portrays the "equity" that federal stakeholders (taxpayers, elected officials, etc.) have in the entity. However, unlike conventional balance sheets, this "equity" is comprised of unexpended appropriations i.e. budget authority available at fiscal year end which has not yet been expended for goods and services or future funding requirements.

As with the assets and liabilities described above, a net position section is separately presented for custodial and operating categories. In this manner, the custodial and operating categories are self-balancing, essentially producing separate statements of financial position for the custodial and operating aspects of the Service.

The custodial net position is comprised of unexpended appropriations relating to funds with the Treasury available for the payment of refunds and revolving fund disbursements. In addition, future funding requirements, which represent future appropriations required to meet current accruals, are included. The operating net position is also comprised of unexpended appropriations. Also, the operating net position is comprised of invested capital, which offsets the inventory amounts, and future funding requirements. The fiscal year 1992 future funding requirements are comprised primarily of unfunded annual leave.

INTERNAL REVENUE SERVICE
Overview to Financial Statements
for the Fiscal Year Ended September 30, 1992

Collections and Transfers

The Statement of Collections and Operations presents fiscal year activity relating to both Service collection activity as well as appropriations received and expended for goods and services used in internal operations.

As the nation's tax collector, collection of all revenue and related transfers to the Treasury are presented to sufficiently disclose all financial activity relating to the Service. No portion of Service collections are retained by the Service, but rather, are transferred to the Treasury. Service collections are comprised primarily of individual and business as well as excise, FICA and federal unemployment taxes. Collections are also comprised of reimbursement payments, which represent fees for services to the public and other federal agencies. Such collections are also transferred to the U.S. Treasury.

Financing Sources and Operating Expenditures

Financing sources reflect appropriations received and actually expended on goods and services received by the Service. Operating expenditures reflect all expenses incurred by the Service during the fiscal year, including the purchase of fixed assets and supplies.

Principal Financial Statements

Department of the Treasury

Internal Revenue Service

Principal Financial Statements

Fiscal Year 1992

Statement of Financial Position

Statement of Collections and Operations

Statement of Cash Flows for Appropriated Funds

Statement of Budget and Actual Obligations

Notes to Principal Financial Statements

Statement of Financial Position

Department of the Treasury
Internal Revenue Service
Statement of Financial Position
As of September 30, 1992

Dollars in Millions	
Custodial Assets *(managed on behalf of the federal government, not available for use in internal operations)*	
Federal tax receivables, net (Note 2)	$21,564
Funds with U.S. Treasury (Note 3)	768
Revolving fund assets (Note 4)	10
Other custodial assets (Note 5)	37
Seized property and monies (Note 6)	797
Total Custodial Assets	$23,176
Operating Assets *(relating to internal operations, funded by Congressional appropriations)*	
Financial Resources	
Funds with U.S. Treasury and cash (Note 3)	$1,138
Receivables, non-federal	14
Advances and prepayments, non-federal	19
Intragovernmental items:	
Receivables, federal	167
Advances and prepayments, federal	49
Total Financial Resources	1,387
Non-Financial Resources	
Property and equipment (Note 7)	
Inventory	8
Total Non-Financial Resources	8
Total Operating Assets	$1,395

The accompanying notes are an integral part of these statements.

Department of the Treasury
Internal Revenue Service
Statement of Financial Position
As of September 30, 1992

Dollars in Millions	
Custodial Liabilities *(offsets Custodial Assets)*	
Due to U.S. Treasury	$21,601
Other custodial liabilities (Note 8)	2,883
Seized property and monies (Note 6)	797
Commitments and contingencies (Note 9)	
Total Custodial Liabilities	25,281
Custodial Net Position *(offsets Custodial Assets)*	
Unexpended appropriations	215
Unexpended appropriations, revolving fund (Note 4)	10
Less: Future funding requirements (Note 10)	(2,330)
Total Custodial Net Position	(2,105)
Total Custodial Liabilities and Net Position	$23,176
Operating Liabilities *(relating to internal operations)*	
Funded Liabilities	
Accounts payable, non-federal (Note 3)	$349
Deposit funds	12
Accrued payroll and benefits	283
Payables, federal	25
Total Funded Liabilities	669
Unfunded accrued annual leave (Note 10)	294
Unfunded commitments and contingencies (Notes 9 and 10)	9
Total Operating Liabilities	972
Operating Net Position *(relating to internal operations)*	
Unexpended appropriations (Note 11)	718
Invested capital	8
Less: Future funding requirements (Note 10)	(303)
Total Operating Net Position	423
Total Operating Liabilities and Net Position	$1,395

The accompanying notes are an integral part of these statements.

Statement of Collections and Operations

Department of the Treasury
Internal Revenue Service
Statement of Collections and Operations
For the Year Ended September 30, 1992

Dollars in Millions		
Collections and Transfers		
Collections of federal revenue (Note 12)		
Income taxes	$665,367	
Estate and gift taxes	11,479	
Excise taxes	33,565	
Employment taxes	398,727	
Penalties and interest	11,662	$1,120,800
Revolving fund sales (Note 4)		6
Other		322
Total Collections		1,121,128
Less: Refunds and other payments (Note 12)	113,108	
Revolving fund costs (Note 4)	6	(113,114)
Net Collections		1,008,014
Less: Net transfers to Treasury (Note 12)		(1,008,014)
Excess of Net Collections over Net Transfers to Treasury		$0

The accompanying notes are an integral part of these statements.

Department of the Treasury
Internal Revenue Service
Statement of Collections and Operations (continued)
For the Year Ended September 30, 1992

Dollars in Millions	
Financing Sources	
Appropriations expended	$6,163
Reimbursements, public	2
Reimbursements, intragovernmental	115
Other receipts	54
Less: Receipts transferred to Treasury	(54)
Total Financing Sources	6,280
Operating Expenditures	
Administration and management	119
Processing tax returns and assistance	1,613
Tax law enforcement	3,563
Information systems	974
Total Operating Expenditures	6,269
Excess of Financing Sources over Operating Expenditures	11
Less: Adjustment for Net Unfunded Expenses	(11)
Excess of Financing Sources Over Funded Expenses	$0

The accompanying notes are an integral part of these statements.

Statement of Cash Flows for Appropriated Funds

Department of the Treasury
Internal Revenue Service
Statement of Cash Flows for Appropriated Funds
As of September 30, 1992

Dollars in Millions	
Cash Flows From Financing Activities	
Appropriations received (Note 13)	$6,680
Reimbursements	117
Net Cash Provided by Financing Activities	6,797
Cash Flows Used for Operating Activities	
Funded Expenses	6,280
Adjustments Affecting Cash Flow	
Increase in receivables	78
Decrease in advances and prepayments	(48)
Decrease in funded liabilities	241
Net Cash Used for Operating Activities	6,551
Net Cash Provided by Operating and Financing Activities	246
Funds with U.S. Treasury and Cash, Beginning	892
Funds with U.S. Treasury and Cash, Ending (Note 3)	$1,138

The accompanying notes are an integral part of these statements.

Statement of Budget and Actual Obligations

Department of the Treasury
Internal Revenue Service
Statement of Budget and Actual Obligations
For Fiscal Year Ended September 30, 1992

Dollars in Millions

Program Name	Total Budget Authority	Obligations Incurred
Executive Direction	$13	$13
Procurement	3	3
Planning and Research	13	13
Finance	18	18
Human Resources	9	8
Internal Audit and Internal Security	90	90
Returns Processing	954	949
Statistics of Income	23	23
Taxpayer Services	296	296
Tax Fraud and Financial Investigations	336	333
Examination	1,352	1,351
Employee Plans and Exempt Organizations	120	120
International	45	45
Collection	771	770
Document Matching – Returns Processing/Collections	91	91
Appeals and Legal Services	362	361
Processing and Services	12	12
Compliance and Enforcement	20	20
Tax Systems Modernization	39	39
Information Systems Management	447	438
Information Systems Development	306	203
Training	60	59
Information Systems Support	425	350
Standard Level Users Charge	476	476
Support and Resources Management	578	572
Section 523A Travel Reduction	9	0
Total	$6,868	$6,653

Total Obligations Incurred	$6,653
Add: September 30, 1991 Undelivered Orders	170
Unreconciled Variance	3
Less: September 30, 1992 Undelivered Orders (Notes 9 and 11)	(534)
Adjustment for Net Unfunded Expenses	(11)
Deobligation of Prior Year Funds	(12)
Total Operating Expenditures	$6,269

The accompanying notes are an integral part of these statements.

Notes to Principal Financial Statements

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Year Ended September 30, 1992

Note 1. Significant Accounting Policies

A. Reporting Entity

The Internal Revenue Service (the Service) is a bureau of the U.S. Department of the Treasury (Treasury). The Service was created in 1862 when the Congress established the Office of the Commissioner of the Internal Revenue. In 1952 the Bureau was reorganized by the Congress and in 1953 became the Internal Revenue Service.

The mission of the Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of its products and services; and perform in a manner warranting the highest degree of public confidence in Service integrity, efficiency and fairness.

In fulfilling its mission, the Service maintains a variety of appropriated, trust and revolving funds. The accompanying principal financial statements of the Service include the accounts of all funds under Service control. All intra-agency balances and transactions have been eliminated. In addition, amounts relating to the GSA Building Delegation Allocation Account have been excluded from these financial statements.

B. Accounting Standards

Fiscal year 1992 is the first year that the Service has prepared principal financial statements in accordance with the Chief Financial Officers Act of 1990 (CFO Act). This legislation mandated changes in financial management and reporting in federal agencies, including the preparation of principal financial statements with footnotes.

In October 1990, principals of the Joint Financial Management Improvement Program (JFMIP) established the Federal Accounting Standards Advisory Board (FASAB) to consider and recommend accounting standards for the federal government. In March, 1991 the FASAB issued interim guidance on accounting standards, recommending that federal agencies prepare financial statements using applicable standards, including those currently in effect within the agency.

Except as noted below, guidance in the preparation of financial statements and notes was obtained primarily from the Office of Management and Budget (OMB) Bulletin No. 93-02, *Form and Content of Agency Financial Statements*. Additional guidance was obtained from Service policy and procedure manuals. Financial statements prepared in accordance with this guidance are considered to be statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Year Ended September 30, 1992

Note 1. Significant Accounting Policies (continued)

C. Basis of Accounting

Federal revenue is reported on the cash basis of accounting, i.e. when remittances are received. Refunds are also reported on the cash basis of accounting. Tax receivables and an offsetting liability to the U.S. Treasury are presented in the Statement of Financial Position to more accurately present the financial position of the Service; however, this treatment has no effect on tax revenues reported in the Statement of Collections and Operations. Liabilities for the refund of tax payments are not accrued until related tax returns are filed.

The current fiscal year acquisition cost of all property, equipment and supplies are reported within operating expenditure categories in the Statement of Collections and Operations. Appropriations are expended in amounts equal to these property and equipment expenditures. Property and equipment are not depreciated. The acquisition cost for property and equipment has not been capitalized and reported in the Statement of Financial Position. Rather, the acquisition cost for selected property and equipment is reported in Note 7 only.

All other transactions are recorded on the accrual basis of accounting. Under this method, revenues and financing sources are recognized when earned and expenses are recognized when incurred, without regard to the receipt or payment of cash. Appropriations are recognized as a financing source upon the incurrence of the related expense, i.e. when the appropriation is expended. Reimbursements are recognized as a financing source as the related reimbursable costs are incurred.

Operating expenditures in the Statement of Collections and Operations are presented by appropriation rather than object class.

D. Custodial Assets and Liabilities

Current guidance recommends that assets be reported in "Financial" or "Non-Financial" categories. However, due to the nature and amount of specific assets, and to more accurately present the financial position of the Service, an additional category was created. This category, entitled "Custodial Assets", presently includes federal tax receivables, funds for the payment of refunds, assessments and other resources. These custodial assets total $23.2 billion. In contrast, the financial and non-financial assets currently reported total approximately $1.4 billion.

The custodial assets are offset by a separate "custodial" net position category to further highlight the effect these resources have on the financial position of the Service. In addition, an unfunded custodial liability for advance payments is offset by a future funding requirement in the custodial net position section.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Year Ended September 30, 1992

Note 1. Significant Accounting Policies (continued)

E. Operating Assets and Liabilities

Financial and Non-Financial Resources of the Service are presented on the Statement of Financial Position as "Operating Assets".

Funded and unfunded liabilities of the Service, outside the realm of custodial liabilities, are presented as "Operating Liabilities". A separate "Operating Net Position" section is also provided to further delineate operating and custodial aspects of the Service.

F. Budgets and Budgetary Accounting

Financing sources are provided through congressional appropriations on an annual, multi-year and no-year basis. Appropriations are used to finance operating expenses and purchase property and equipment as specified by law. Appropriations are also received to meet program obligations, including payments on the earned income tax credit and interest on tax refunds.

A permanent, indefinite appropriation, which does not require consideration by Congress during the annual appropriation process, is available for the payment of tax refunds.

G. Federal Tax Receivables

Federal tax receivables are comprised primarily of taxes, penalties and interest assessed under provisions of the Internal Revenue Code which remain uncollected at September 30, 1992. Accrued interest and penalties are also included. The balance reported is net of estimated uncollectible amounts. At GAO's recommendation, IRS valued the reported collectibility of receivables by examining a sample of 2,600 accounts. As a custodial asset, federal tax receivables are offset by a corresponding custodial liability, which represents the amount of receivables transferable to the U.S. Treasury upon collection.

H. Funds With U.S. Treasury - Custodial

This custodial asset is comprised primarily of the undisbursed amount remaining under a warrant received for the payment of tax refunds. The balance is comprised of appropriations received for the payment of interest on tax refunds and earned income credit payments.

The payment of tax refunds is based on a permanent, indefinite appropriation as contained in 31 U.S.C. 1324. However, as with other appropriations, actual authority for payment is contingent upon the execution of a warrant. Consequently, the undisbursed balance remaining under this warrant was deemed to best represent those funds with the U.S. Treasury available for the payment of tax refunds.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Year Ended September 30, 1992

Note 1.
Significant
Accounting
Policies
(continued)

I. Funds With U.S. Treasury and Cash - Operating

This line item, included within the "Operating Asset" category, is comprised primarily of funds available at the U.S. Treasury to meet authorized operating liabilities and other purchase commitments of the Service.

J. Advances and Prepayments

Payments in advance of the receipt of services are reported as prepaid charges at the time of prepayment and recognized as expenses when the related services are received.

K. Property and Equipment

The land and buildings occupied by the Service are provided by the General Services Administration (GSA). GSA charges the Service a Standard Level Users Charge (SLUC), which approximates commercial rental rates for similar properties. Additions to property and equipment, costs for leasehold improvements, and operating and capital leases are expensed as payments are made.

L. Inventory

The inventory of the Service is comprised of unissued supplies that will be consumed in future operations. The inventories on hand at year end are stated at the lower of cost (using the first-in, first-out method) or market value. The recorded values are adjusted for the results of physical inventories taken at fiscal year end. Expenditures are recorded upon consumption of the inventory by the Service.

M. Leave and Retirement Plans

Annual leave is accrued as it is earned and reduced as it is taken. Each year, the balance in the accrued annual leave account is adjusted to reflect current rates. Funding for accrued annual leave will be expended when the leave is taken in the future. Sick leave and other types of nonvested leave are expended as taken.

Most employees hired before January 1, 1984 participate in the Civil Service Retirement System (CSRS), to which the Service makes matching contributions equal to approximately 7 percent of pay.

The Service does not report CSRS assets, accumulated plan benefits or unfunded liabilities, if any, applicable to its employees. Reporting such amounts is the responsibility of the Office of Personnel Management.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Year Ended September 30, 1992

Note 1. Significant Accounting Policies (continued)

On January 1, 1984, the Federal Employees Retirement System (FERS) went into effect pursuant to Public Law 99-335. Most employees hired after December 31, 1983, are automatically covered by FERS and Social Security. Employees hired prior to January 1, 1984, could elect to join FERS and Social Security or remain in CSRS. A primary feature of FERS is that it offers a savings plan to which the Service automatically contributes 1 percent of pay and matches any employee contribution up to an additional 4 percent of pay. For employees covered by FERS, the Service also contributes the employer's matching share for Social Security.

N. Operating Net Position

Operating Net Position is comprised of the following three components:

Unexpended Appropriations - The amount of all unexpended budget authority, both available and unavailable, plus undelivered orders at fiscal year end.

Future Funding Requirements - The amount of future appropriations that will be necessary, beyond the September 30, 1992 fiscal year end, to liquidate September 30, 1992 unfunded liabilities.

Invested Capital - The inventory of supplies, not consumed as of September 30, 1992.

O. Collections

The Service has been given the authority to collect and remit certain revenues to various agencies, including the Treasury. The following are the major revenue sources which fall under Service jurisdiction:

Income Taxes - Federal income taxes paid by individuals, businesses, estates and trusts under Subtitle A of the Internal Revenue Code (IRC).

Estate and Gift Taxes - Taxes paid under Subtitle B of the IRC.

Employment Taxes - The collection of employment taxes under Subtitle C of the IRC is administered by the IRS on behalf of other federal agencies. Pursuant to the Social Security Act, as amended by P.L. 94-202 effective January 1, 1978, Social Security taxes are collected through the Federal Tax Deposit (FTD) system and remitted to the Social Security trust fund. Federal unemployment taxes are also collected through the FTD system and remitted to the Department of Labor.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Year Ended September 30, 1992

Note 1. Significant Accounting Policies (continued)

Excise Taxes - Various excise taxes paid under Subtitle D of the IRC. Subtitle E excise taxes on alcohol, tobacco and firearms are not collected by the Service. Rather, these excise taxes are collected by the Bureau of Alcohol, Tobacco and Firearms.

Penalties and Interest - Fines assessed for violations or late charges and interest charged for delinquent payment of taxes.

P. Statement of Budget and Actual Obligations

The Statement of Budget and Actual Obligations is presented by management activity code (MAC) rather than budget activity code (BAC). Management Activities are used in Financial Plan formulation and execution. Some are prorated to more than one appropriation while others are entirely within a single appropriation. Budget Activities are subdivisions of Service appropriations into major programs for purposes of the federal budget.

Q. Comparative Data

Comparative data for the prior year have not been presented as this is the first year for which principal financial statements with notes have been prepared for the Service. Comparative data will be presented in subsequent years.

R. Transactions in Process

Transactions in process at year end are not reflected in the accompanying financial statements. These transactions in process include assessments, collections, adjustments, abatements, and other items. The Service did not analyze such transactions, exceeding $150 billion at September 30, 1992, to determine which should have been reported in fiscal year 1992.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Year Ended September 30, 1992

Note 2. Federal Tax Receivables

Federal tax receivables include unpaid taxes, penalties and interest assessed and accrued, reduced by an estimate of uncollectible amounts. Prior to September 30, 1992, the Service used several methods for determining reported accounts receivable which overstated amounts collectible. Based upon the method recommended by GAO, the Service developed and reported an estimate of $21.6 billion for collectible receivables as of September 30, 1992. This estimate was based on a collectibility analysis of a sample of 2,600 separate accounts. An estimate of gross valid accounts receivable as of September 30, 1992 was not determined. The Service is investigating long-term solutions to systematically determine valid and collectible accounts receivable balances.

Accounts receivable result from vigorous tax administration as well as taxpayers failing to meet their obligations. Accounts receivable are resolved when collected, abated (e.g., removed from inventory upon discovery of an error, acceptance of an offer-in-compromise, or discharge due to bankruptcy) or purged from inventory when the collection statute of limitations expires.

Federal tax receivables, combined with other custodial liabilities, are offset by amounts due to U.S. Treasury.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Year Ended September 30, 1992

Note 3. Funds with U.S. Treasury

Funds with U.S. Treasury are reported in both the Custodial and Operating sections of the Statement of Financial Position. Funds with U.S. Treasury balances are adjusted to conform with balances reported by the Department of Treasury. Variances are due to unresolved cash differences in transactions between the Service's general ledger and Treasury's Undisbursed Appropriation Account Ledger, TFS 6653. As of September 30, 1992 these unresolved differences were approximately $18 million in the custodial section and $112 million in the operating section. The amount shown for Operating accounts payable, non-federal has been affected by these unresolved differences. The majority of the $183 million difference between the reported accounts payable non-federal and the general ledger is attributed to cash reconciling items. Deposit and clearing funds represent cash held for others and cash items pending investigation and recording into appropriate accounts.

The Custodial portion was comprised of the following at September 30, 1992:

(Dollars in Millions)

Appropriated Funds	$637
Deposit and Clearing Funds	131
Funds with U.S. Treasury - Custodial	$768

Funds with U.S. Treasury, reported in the Operating section, reflect the total of all undisbursed account balances with the U.S. Treasury to meet authorized operating liabilities and purchase commitments of the Service. The restricted portion of these funds is related to expired budget authority.

Funds with U.S. Treasury in the Operating section was comprised of the following at September 30, 1992:

(Dollars in Millions)	Available	Restricted	Total
1992 Appropriations	$ 514	$ 8	$ 522
1991 Appropriations	101	7	108
1990 Appropriations	25	17	42
1989 Appropriations	22	19	41
Merged Appropriations		4	4
Multi-Year funds (Hurricane Andrew Relief Fund)	1		1
No-Year Appropriations, including Tax Systems Modernization	404		404
Deposit and Clearing Funds	12		12
Cash-Imprest Funds	4		4
Funds with U.S. Treasury and Cash - Operating	$1,083	$55	$1,138

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Year Ended September 30, 1992

Note 4. Revolving Fund

The Federal Tax Lien Act of 1966 authorized the creation of a revolving fund for the redemption of real property on which a tax lien has been filed. The fund was established under permanent authority and is therefore available without fiscal year limitation.

In accordance with Section 7425 of the IRC and Section 2410 of Title 28, the revolving fund can be used to redeem real property foreclosed upon by a holder of a lien which is superior to the tax lien. Real property is redeemed when the Service pays the lienholder the amount bid at sale plus interest and certain post-sale expenses. The Service may then sell the property, reimburse the fund and apply the net proceeds to the outstanding tax obligation.

The revolving fund is reimbursed from the proceeds of the sale in an amount equal to the outlay from the fund for the redemption. The balance of the proceeds is applied against the amount of the tax, interest, penalties and the costs of sale. The remainder, if any, would revert to the parties legally entitled to it.

The revolving fund is comprised of the following at September 30, 1992:

(Dollars in Millions)

Fund Assets:	
Funds with U.S. Treasury	$ 7
Land and Building Inventory	3
Total Fund Assets	$10
Fund Net Position:	
Unexpended Appropriation - revolving fund	$10

Note 5. Other Custodial Assets

The category "Other Custodial Assets" relates to program items of the Service transferable to the Treasury upon their collection. Other Custodial Assets have not been adjusted for an allowance for doubtful accounts. Other Custodial Assets are comprised of manual assessments of $37 million at September 30, 1992.

Manual assessments encompass jeopardy, prompt and termination assessments not yet recorded to individual and business master files. Manual assessments are made when collection of a tax deficiency is jeopardized due to an impending expiration of a statute. In addition, manual assessments are utilized to expedite collection of taxes relating to criminal activity and bankruptcy.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Year Ended September 30, 1992

Note 6. Seized Property and Monies

Seized property and monies of the Service originate from its collection activities and its role in criminal investigations.

The Internal Revenue Code (IRC) authorizes the Service, as part of its collection activities, to seize property and monies in order to compel payment for delinquent tax obligations. The IRC prescribes detailed procedures for the seizure of property and monies, including proper methods for notifying parties and details of sale. Seized property and monies are held and safeguarded by the Service until such time as the taxpayer has exhausted available remedies under the law. Generally, the seized property is sold and the proceeds used to satisfy the delinquent tax obligation.

The IRC also authorizes the seizure of property and monies resulting from investigations conducted by Criminal Investigation personnel of the Service. Property and monies are seized as part of the forfeiture laws pertaining to property used for criminal purposes. These seizures occur primarily from IRS jurisdiction over violations of the IRC or money laundering crimes as provided in Title 18, U.S.C.

The Service temporarily retains custody of seized cash and personal (non-real) property under $500,000 estimated value. After property and monies in IRS custody are forfeited in an administrative hearing, cash is transferred to the general fund of the U.S. Treasury. All property valued over $500,000 and all real property is transferred to the U.S. Marshall Service for disposition. Other property is transferred to the Justice Department's Asset Forfeiture Fund or is placed into official use.

Criminal Investigation personnel may place certain forfeited properties (other than seized monies) into official use. When this occurs, the forfeited property is recorded in the fixed asset accounting system. The Service is performing a reconciliation of seized property and monies recorded in the general ledger to seizure records in the district offices. There may be a significant adjustment to the amounts reported below. Seized property and monies recorded in the general ledger were comprised of the following at September 30, 1992:

(Dollars in Millions)

Collateral	$260
Seized Property	499
Acquired Property	4
Seized Monies	34
Assets, Seized Property and Monies	$797

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Year Ended September 30, 1992

Note 7. Property and Equipment

The Service's criterion for capitalization of property and equipment is a useful life of more than one year and a unit cost of $5,000 or more. Current fair market value is used for property and equipment transferred at no cost to the Service from other agencies. However, due to systems limitations and control weaknesses, additions to property and equipment are expensed in the current period. Consequently, complete and accurate information on property and equipment was not available for reporting in the financial statements.

Complete acquisition cost data was not available for the following categories: mini and micro computers, peripherals, software, National Office's non-ADP assets, Criminal Investigation's law enforcement vehicles and sensitive investigative equipment, telecommunications equipment purchased with field funds, Communications Replacement System equipment and Automatic Call Distributers/Audio Response Units purchased before October 1, 1987 with National Office funds. Currently, system and procedural enhancements are underway to improve the reporting of property and equipment maintained by the Service.

Physical inventories were used as the basis for reporting the cost of mainframe computers. The Property Assets Tracking System provided the non-ADP assets information. Management information systems were utilized for the telecommunications equipment information. Partial information on property and equipment consisted of the following as of September 30, 1992:

(Dollars in Millions) Classes of Property and Equipment	Service Life	Acquisition Cost
Mainframe CPU's,		
Computing and Service Centers	15	$107
Furniture	8	10
Non-ADP equipment	10	19
Investigative equipment	10	19
Law enforcement vehicles	3	44
Sensitive investigative equipment	10	6
Telecommunications equipment	15	77
Total		$282

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Year Ended September 30, 1992

Note 8. Other Custodial Liabilities

The category "Other Custodial Liabilities" relates to current liabilities to taxpayers for tax refunds due on filed returns and voluntary advance payments made in anticipation of additional tax, penalties and interest. It also includes the liability for taxpayer deposits and clearing account liabilities. The category "Other Custodial Liabilities" was comprised of the following at September 30, 1992:

(Dollars in Millions)

Tax Refunds Payable	$ 422
Advance Payments	2,330
Deposit Funds	25
Clearing Funds	106
Total	$2,883

Note 9. Unfunded Commitments and Contingencies

The Service has made obligations for goods and services which have been ordered but not yet received (undelivered orders) at fiscal year end. Aggregate undelivered orders for all Service activities amounted to $534 million as of September 30, 1992.

As of September 30, 1992 the Service recorded contingent liabilities of $9 million for pending and threatened legal matters for which it is probable, in the opinion of Service management and legal counsel, that the Service will incur a liability.

The Service is also involved in various legal actions in connection with which the United States will probably be liable for amounts payable from the Judgement Fund administered by the Justice Department in accordance with 31 U.S.C. 1304 and therefore are not reported in the statements. In the opinion of Service management and legal counsel, it is probable that approximately $46 million will be payable from the Justice Department Judgement Fund for judgements and settlements relating to Service litigation and claims.

Tax examinations often result in proposed additional taxes which may later be assessed and collected. Prior to assessment, proposed adjustments are considered a contingent gain and are not reported in the statements. These proposed adjustment fall into two categories: 1) proposed additional taxes held in suspense pending the statutory period for taxpayer response, and 2) cases for which the taxpayer has requested an administrative appeal. Due to uncertainties concerning the amount which will eventually be realized from proposed tax adjustments, no estimate of contingent gain is set forth in the statements.

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Year Ended September 30, 1992

Note 10. Future Funding Requirements

Future funding requirements are an offset, in the Net Position Section, to unfunded liabilities. As an offset to unfunded liabilities, they represent expenses incurred and unpaid as of fiscal year-end for which appropriations for their payment have not yet been provided. Future funding requirements were comprised of the following at September 30, 1992:

(Dollars in Millions)

Custodial Items:	
Unfunded liability for advance payments	$2,330
Operating Items:	
Unfunded accrued annual leave	294
Unfunded accrued contingent liability	9
Future Funding Requirements Operating Section	$ 303

Note 11. Unexpended Appropriations

The category "Unexpended Appropriations" within the Operating Net Position section reflects total budget authority available and unavailable for obligations, plus undelivered orders. Unexpended Appropriations were $76 million less than the amount reported on FMS 2108, the year-end closing statement, as a result of cash related adjustments. Unexpended Appropriations were comprised of the following at September 30, 1992:

(Dollars in Millions)

	Appropriated Funds
Unexpended Appropriations:	
Available	$129
Unavailable	55
Undelivered Orders	534
Total Unexpended Appropriations	$718

INTERNAL REVENUE SERVICE
Notes to Principal Financial Statements
for the Fiscal Year Ended September 30, 1992

Note 12. Collections of Federal Revenue, Refunds and Net Transfers

The following amounts comprise revenues collected, refunds and net transfers to Treasury for the year ended September 30, 1992:

(Dollars in Millions)

	Collections	Refunds(2)	Net Transferred
Income Taxes			
Individuals	$ 553,507	90,013	463,494
Corporations	111,860	19,689	92,171
Estate and Gift	11,479	401	11,078
Excise (3)	33,565	1,997	31,568
Employment Taxes			
FICA(1)	364,192	834	363,358
SECA	24,421	—	24,421
Railroad Retirement	4,359	19	4,340
FUTA	5,755	155	5,600
Penalties and Interest	11,662	—	11,662
Total Taxes	$1,120,800	$113,108	$1,007,692

(1) All collections of federal income tax withholding and FICA are first applied to pay FICA liability in full, regardless of the amount paid. The balance is then credited to federal income tax.

(2) Refunds include principal and interest.

(3) Detail of excise taxes is included in Supplemental Financial and Management Information section of this report.

The allocation of federal revenues to the general fund and trust funds is detailed in Supplemental Financial and Management Information.

INTERNAL REVENUE SERVICE
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Note 13. Appropriations Received

Appropriations received for the fiscal year ended September 30, 1992 were comprised of the following:

(Dollars in Millions)

Annual Funds:	
Appropriation 1	$ 141
Appropriation 2	1,657
Appropriation 3	3,584
Appropriation 4	860
No-Year Funds:	
Appropriation 3	2
Appropriation 4	435
Multi-Year Funds:	
Appropriation 3	1
Total	$6,680

Supplemental Financial and Management Information

Department of the Treasury

Internal Revenue Service

Supplemental Financial and
Management Information

Fiscal Year 1992

Allocation of Revenue and Excise Taxes

•

Financial Statement and Account Definitions

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Objectives and Strategies

•

Tax Systems Modernization

INTERNAL REVENUE SERVICE
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ALLOCATION OF REVENUE AND EXCISE TAXES

Allocations of Revenues to Funds

The source of data for Allocations of Revenues to Funds is the Department of Treasury, Financial Management Service.

(Dollars in Millions)

General Fund of the U.S. Treasury	$ 691,285
Social Security Trust Funds (1)	395,258
Unemployment Trust Fund	5,755
Railroad Retirement Board Fund	4,359
Excise Tax Funds:	
Highway Trust Fund (2)	16,733
Airport and Airways	4,645
Environmental Superfund	1,198
Black Lung Disability	626
Leaking Underground Storage Tanks	159
Oil Spill	295
Aquatic Resources-Sport Fish	229
Boat Safety	70
Vaccine Injury Compensation	118
Inland Waterways	70
Total Allocations of Revenue	$1,120,800

(1) Allocation to Social Security trust funds includes FICA of $365 billion, SECA of $24 billion, income tax on Social Security income of $6 billion and tax refund offsets of $40 million.

(2) Net of $194 million reallocated by Treasury: $123 million to Sport Fish, $70 million to Boat Safety and $1 million to Land and Water.

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
For the Fiscal Year Ended September 30, 1992

Excise Tax Revenues

(Dollars in millions)

General Fund Excise Taxes:	
Telephone Services	$ 3,173
General Fund Portion of Highway Taxes	3,395
General Fund Portion of Airport/Airways	18
Ozone Depleting Chemicals	568
Luxury Taxes	305
Exempt Organizations/Emp. Pension and Benefits	470
Miscellaneous excise taxes (1)	69
Unclassified excise taxes	492
Trust Fund Excise Taxes:	
Highway Trust Fund (2)	18,051
Airport and Airways	4,762
Environmental Superfund	808
Black Lung Disability	626
Leaking Underground Storage Tanks	230
Oil Spill	277
Aquatic Resources-Sport Fish (2)	85
Boat Safety (2)	-0-
Vaccine Injury Compensation	165
Inland Waterways	71
Total Excise Tax Revenues	33,565
Less: Refunds	1,997
Net Excise Tax Revenues	$31,568

Detailed information in the table above is based on net tax liabilities reported on excise tax returns. The balance of the adjustment needed to report total excise tax revenues is included in Unclassified Excise Taxes.

(1) Miscellaneous excise taxes include foreign insurance, cruise ship passengers, gas guzzler, windfall profits, real estate investment trusts, regulated investment companies, wagering, bows and arrows, foreign transfers of property and greenmail.

(2) Amounts do not reflect a reallocation made by Treasury of $194 million from the Highway Fund: $123 million to Sport Fish, $70 million to Boat Safety, and $1 million to Land and Water.

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
For the Fiscal Year Ended September 30, 1992

FINANCIAL STATEMENT AND ACCOUNT DEFINITIONS

A. Statement of Financial Position

The Statement of Financial Position presents Service assets (resources), liabilities and net position (the difference between assets and liabilities). To clarify financial reporting, line items have been divided into two major categories. Statement of Financial Position line items are reported in either "Custodial" or "Operating" categories. Custodial assets are primarily tax receivables, seized property and funds restricted for refunds. These assets are offset by Custodial Liabilities. However, additional custodial liabilities exist which are unfunded and hence do not offset an asset. These custodial liabilities are offset as future funding requirements to the Net Position section.

All remaining financial statement line items are included within the "Operating" category. These line items relate directly to the operating needs of the Service and include such items as Funds with Treasury (for the payment of operating costs), non-tax receivables, and property and equipment.

Custodial Assets

(1) Custodial Assets - This heading describes assets which are programmatic rather than operational in nature. An example of Custodial Assets are federal tax receivables. These assets are programmatic as they relate to the broad program mission of the Service and not its internal operating needs.

(2) Federal Tax Receivables - The net receivable amount from taxes, including individual, corporate, payroll, etc. The receivables are presented net of an allowance for doubtful collections.

(3) Funds With U.S. Treasury - Funds available under a permanent, indefinite appropriation primarily for the payment of tax refunds and interest on tax refunds. These appropriations cannot be used for operating needs of the Service. Consequently, it is classified as a Custodial Asset.

(4) Revolving Fund Assets - Funds with U.S. Treasury and inventory which relate to the Federal Tax Lien Revolving Fund.

(5) Other Custodial Assets - Comprised primarily of manual assessments in transit.

(6) Seized Property and Monies - Primarily relates to seized property and monies held by the Service pending a judicial or administrative proceeding. Also, included on this line is deposit funds, seized monies held with the U.S. Treasury.

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
For the Fiscal Year Ended September 30, 1992

Operating Assets

(7) Operating Assets - Operating assets are all financial statement line items which relate directly to the operating needs of the Service. These items include funds available to pay operating costs, non-tax receivables and property and equipment.

(8) Financial Resources - This heading describes available financial resources to meet current or future operational needs of the Service (as opposed to Custodial Assets, which are used for programmatic purposes).

(9) Funds with U.S. Treasury and Cash - Undisbursed appropriations available for Service expenditures. Much of this balance will be used for undelivered orders and payables in existence at fiscal year end. This line item also includes deposit funds, budget clearing accounts and imprest funds.

(10) Receivables, Non-Federal - Total receivables due from non-federal sources, including but not limited to vendor and salary overpayments, cost of living adjustments, and travel advances.

(11) Advances and Prepayments, Non-Federal - Total payments made in advance of the receipt of goods or services, where the advance or prepayment was made to a non-federal source.

(12) Intragovernmental Items - Receivables and Advances/Prepayments relating to activity with other federal agencies, eg. reimbursables and refunds from other government agencies.

(13) Non-Financial Resources - Those assets which cannot, either because of existing need or by law, be easily sold or converted into financial resources.

(14) Property and Equipment - This line item appears in the Statement of Financial Position to remind the reader of the existence of property and equipment in use by the Service. However, an actual dollar amount is not reported in the statement itself. Rather, selected property and equipment amounts are reported in Note 7.

(15) Inventory - Supplies held for future consumption by the Service.

Custodial Liabilities and Net Position

(16) Custodial Liabilities - Liabilities which offset certain Custodial assets.

(17) Due to U.S. Treasury - The offset to the Tax Receivables asset and other custodial assets.

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
For the Fiscal Year Ended September 30, 1992

(18) Other Custodial Liabilities - Tax refunds actually approved for payment, advance payments, and deposit and clearing funds.

(19) Seized Property and Monies - The offset to the asset Seized Property and Monies.

(20) Commitments and Contingencies - In the case of the Service, amounts which may be receivable or payable in the future, for which the final outcome is uncertain.

(21) Custodial Net Position - The difference between Custodial Assets and Liabilities, comprised of Unexpended Appropriations and Invested Capital reduced by Future Funding Requirements.

(22) Unexpended Appropriations - Budget authority relating primarily to the payment of tax refunds. The unexpired portion of warrants processed for the payment of these refunds. Unexpended budget authority for the Federal Tax Lien Revolving Fund is also presented.

(23) Future Funding Requirements - The offset to unfunded liabilities.

Operating Liabilities and Net Position

(24) Operating Liabilities - Liabilities relating to the internal operating requirements of the Service.

(25) Funded Liabilities - Liabilities for which budget authority, revenues, or other sources of funds necessary to liquidate the liabilities has been made. These sources of funds are available through appropriations, earnings or other funding sources as of fiscal year end.

(26) Accounts Payable, Non-Federal - Payables to individuals or non-federal entities, recorded on the accrual basis.

(27) Deposit Funds - The offset to the budget clearing accounts and deposit funds which are included within Funds with U.S. Treasury on the asset side.

(28) Accrued Payroll and Benefits - Includes all funded payroll incurred but unpaid as of fiscal year end.

(29) Payables, federal - Payables to federal entities recorded on the accrual basis.

(30) Unfunded Accrued Annual Leave - Vacation leave which is accrued and recorded but which has not yet been funded.

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
For the Fiscal Year Ended September 30, 1992

(31) Unfunded Commitments and Contingencies - In the case of the Service, amounts which may be due in the future, as a result of lawsuit settlements and contract dispute settlements, for which the final outcome is uncertain.

(32) Operating Net Position - The difference between Operating Assets and Liabilities, comprised of Unexpended Appropriations and Invested Capital reduced by Future Funding Requirements.

(33) Unexpended Appropriations - Authority which is unobligated plus undelivered orders.

(34) Invested Capital - The offset to the supplies inventory.

(35) Future Funding Requirements - The offset to unfunded liabilities.

B. Statement of Collections and Operations

Presents the collections and related transfers of federal revenue to the U.S. Treasury. Presents appropriations used for Service operations and all expenditures of the Service for the fiscal year.

(1) Collections of Federal Revenue - The aggregate of federal revenue collected by the Service during the fiscal year. Collections include individual and business, excise, FICA and federal unemployment taxes, and related penalties and interest.

(2) Other - Miscellaneous taxes, licenses and services performed for the public, federal and other governmental agencies such as the tax refund offset program, child enforcement program, document duplication, etc.

(3) Revolving Fund Sales - Proceeds from the sale of redeemed real property used to offset related costs to acquire and to satisfy tax obligations.

(4) Less Refunds and Other Payments - The refund of taxes, related interest, and earned income credits.

(5) Revolving Fund Costs - Cost of real property sold and administrative costs of the fund.

(6) Net Transfers to the Treasury - Net Federal tax collections transferred to the Treasury. This amount will equal the "Net Collections" amount.

INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
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(7) Appropriations Expended - The amount of appropriations used to fund expenses. This line item includes amounts expended for acquired property and equipment, accrued expenses and unfunded expenses from prior periods that are funded with current period appropriations.

(8) Reimbursements, Public and Intragovernmental - Sums received by the Federal Government as a repayment for commodities sold or services furnished either to the public or to other Government agencies that are authorized by law to be credited directly to specific appropriation and fund accounts.

(9) Other Receipts - Miscellaneous receipts transferred to the Treasury.

(10) Operating Expenditures - These are reported by appropriation on the accrual basis of accounting, which records the expense when it is incurred, without regard to the payment of cash. In addition, property and equipment purchases are included within these expenditure amounts.

(11) Adjustment for Net Unfunded Expenses - Presented as a reduction since the calculated liability for unfunded leave decreased from the prior fiscal year. Unfunded expenses for contingencies are also included.

C. Statement of Cash Flows

Presents increases and decreases to the Operating Fund Balance with Treasury during the fiscal year. Appropriations and reimbursements increase the fund balance while expenditures reduce the fund balance.

D. Statement of Budget and Actual Obligations

Presents total budget authority for current, multi-year and no year appropriations available during the fiscal year. This budget authority is presented by management activity code (MAC). Amounts obligated against this budget authority are also presented by MAC. Data is from ROPE (budget execution) system and is reconciled to General Ledger and SF-133 reports. Reconciling amounts exist because of differences in treatment for certain transactions between ROPE and General Ledger.

INTERNAL REVENUE SERVICE
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OBJECTIVES AND STRATEGIES

Objective #1: Increase Voluntary Compliance

The Internal Revenue Service constantly seeks new ways to more effectively manage its significant resources and diverse programs. The Strategic Management Process was developed as a method for helping us better account for the overall environment in which we operate, the strategic nature of our activities, the interdependence of functions, and our commitment to quality customer service. The Strategic Management Process starts with the Mission Statement. The Strategic Business Plan (SBP) includes three Objectives that describe what we plan to do to fulfill our Mission. To explain how we will meet our Objectives, the SBP is structured along five strategies. The Objectives are equally important and work together toward achieving our Mission; the Strategies are all equally important and support the Objectives.

The public's willingness to meet its tax responsibility is the foundation of our nation's tax system. Ensuring greater voluntary compliance is the most efficient and cost effective approach to collecting the revenues needed to fund our Federal government. Most citizens want to comply with the tax laws. It is our role to assist them in understanding how to meet their tax obligations. We must ensure that the way we administer the tax laws encourages compliance, and that we treat the public with dignity and respect. It is also essential that we enforce the tax laws vigilantly and vigorously against those who intentionally disregard their responsibilities in order to guarantee that all taxpayers pay their fair share.

Objective #2: Reduce Burden on Taxpayers

Taxpayer burden is the time, expense and dissatisfaction experienced by taxpayers, tax professionals and others in complying with the tax laws. To some degree, this burden is an inherent and necessary part of the tax system as taxpayers must keep records, file information and tax returns, and make tax deposits and payments. The challenge to the Service is in improving our system of tax administration so that the number of contacts each taxpayer has with the Service is reduced and the quality of the contacts that take place is improved.

Objective #3: Improve Quality, Productivity, and Customer Satisfaction

Improving the way we do business will reduce the burden on taxpayers and the costs of administering the tax system. We want to satisfy our customers' needs by providing quality products and services which enable and encourage them to meet their obligations. We must reduce the amount of time it takes to answer their questions and resolve their tax filing problems. We must also ensure that the help they request is provided quickly and accurately. To successfully meet these challenges, we are creating new ways of doing our work so that the service we provide is high in quality and satisfies the customer.

INTERNAL REVENUE SERVICE
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For the Fiscal Year Ended September 30, 1992

Strategy #1: Compliance 2000

The Compliance 2000 Strategy focuses on identifying the causes of noncompliance and addressing them by employing taxpayer assistance, education and outreach; making our regulations and procedures clearer and simpler; identifying and encouraging legislative change; and, when warranted, using more focused and sophisticated enforcement techniques.

The tax system works best when taxpayers understand what is expected of them, when the burden of meeting their tax obligations is minimized and when they are given timely, complete and accurate information and assistance that helps them to comply. Compliance 2000 is a philosophy which recognizes that a good part of noncompliance with the tax laws is caused by taxpayers' lack of understanding of what is required. It means we increase our education and assistance efforts as well as take an active role in pushing for improvements in both the tax law and in our own procedures. However, we also recognize that despite our best efforts, some segments of the population will not voluntarily respond. Compliance 2000 includes a focused use of our enforcement tools and resources against noncompliance.

Strategy #2: Tax Systems Modernization

Current IRS computer systems are old, extremely complex and costly to maintain. We are engaged in a long-term modernization effort, known as Tax Systems Modernization (TSM), which will enable the IRS to change the way it does business for transition into the 21st century. The philosophy and concept of TSM is a key to delivering one-stop service, a service that taxpayers have come to know from dealing with commercial businesses such as banks, airlines, credit card companies, and insurance companies.

The TSM strategy is an integrated approach to the design, development and implementation of information systems. TSM will assist us in making a smooth transition to a new way of doing business using state-of-the-art electronic methods for processing tax data. It is not just a way of automating our current operations; TSM will also enable us to reshape the way we work to meet the needs of all our customers for timely, accurate delivery of information. Restructuring the business of IRS with the support of technology will allow us to significantly reduce taxpayer burden, improve voluntary compliance, achieve quality-driven productivity gains, and increase revenue.

Strategy #3: Diversity

The Diversity Strategy focuses on cultural sensitivity and design of appropriate communication methods as key components to providing quality service to the increasingly diverse groups which make up the U. S. population. Diversity in our workplace is an essential strategy in meeting our Objectives. As America's demographics change, the needs of our customers become more diverse, and in order to meet those needs we must understand the underlying differences in perspectives as well as needs.

INTERNAL REVENUE SERVICE
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In the external realm, we must recognize the makeup of the taxpaying public as well as that of the non-compliant citizen. Aging of the population, changing lifestyles, gender, disabilities, geographical location, and immigration are some of the new factors we must consider in our quest to achieve our mission. For example, we are now printing some of our tax forms and instruction guides in Spanish. We must take the extra step to analyze our customer base and then deliver what is necessary for them to comply with the tax laws.

We also realize that it makes good business sense to retain employees who come from many cultural backgrounds and experiences. We are continuously identifying ways in which a diverse work force can assist in meeting our three Objectives and we are committed to continuing our efforts to become an organization in which Equal Employment Opportunity is a way of doing business. Two ways in which we are striving toward this end are: (1) educating our employees on the ways in which valuing and understanding diversity can help us increase voluntary compliance and better serve taxpayers; and (2) increasing representation of minorities and women in managerial positions. Diversity is an effective way to achieve our Objectives now and is an investment in the future.

Strategy #4: Ethics

Our Ethics Strategy helps increase the taxpayers' trust in our ability to administer the tax system fairly and efficiently. It demonstrates our commitment to treating the taxpayer, the taxpayer's representative, and each other with fairness, honesty and impartiality. To achieve our Objectives, we must pay attention to both the way decisions are made and the way they appear inside and outside the Service. Ensuring that we act with the highest standards of professional conduct will help us meet the demands of ethics legislation, Congressional oversight, aggressive media attention and the expressed concerns of taxpayers and their representatives.

The Internal Revenue Service developed a strict code of ethics before the turn of the century, and that code has evolved into one of the toughest sets of rules in the Federal government. However, our management is convinced that the ethical organization of the future must go beyond simply making rules, it must continuously reinforce those rules. We have developed an ethics training program that is required for all employees. The centerpiece of this training is an Ethics Resource Guide, which sets forth our expectations, requirements and resources available for advice in the ethics field. We believe that consistent and outstanding ethical behavior by our personnel is essential to increasing taxpayer voluntary compliance and building their confidence in the products and services we provide.

INTERNAL REVENUE SERVICE
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For the Fiscal Year Ended September 30, 1992

Strategy #5: Total Quality

The Total Quality Strategy requires us to view the Service in terms of the systems we use to produce our products and services. This means we must consider the relationships among our functions, identifying how each function is connected to and impacts the others. This cross-functional approach will be used to improve the quality of what we provide to customers in support of our three Objectives.

We are establishing methods to continuously improve our products and services by identifying what our customers need and want from us; applying systems management concepts and analysis techniques to improve the performance of our systems and streamline operations; developing baselines and measures to determine how successful our products are in meeting our Objectives; decreasing errors and eliminating the need for redoing work, and reducing the cost of producing our products and services. We are also working with the National Treasury Employees Union to involve employees in enhancing the quality of our products and improving customer satisfaction, and encouraging risk-taking and innovation by working to revise and improve the systems we use for reward and recognition.

If we are to achieve excellence in carrying out the Mission, we must change some of the fundamental ways in which we deliver tax administration to our customers and in which we manage our organization. The actions we take to implement our Total Quality Strategy will help us make these changes.

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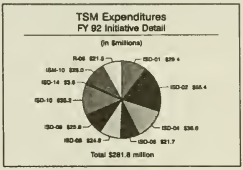
INTERNAL REVENUE SERVICE
Supplemental Financial and Management Information
For the Fiscal Year Ended September 30, 1992

TAX SVSTEMS MODERNIZATION



Expenditures for FY 1992 indicate that progress is being made in many different areas. The initiatives listed in the chart above are summarized below:

ISD-01 **Information Systems Development Program Management**: Overall mission support for the TSM effort.

ISD-02 **Departmental Applications**: Various projects, including Automated Underreporter, Case Processing System, Automated Criminal Investigation, Servicewide Electronic Research Project, Integrated Collection System, Business Area Analyses, and others.

ISD-04 **Systems Integration and Long Term Design**: Includes the functions of systems architecture, data standards, requirements architecture, integration support, program support, system engineering, and configuration management.

ISD-06 **Integrated Input Processing System**: Includes projects for Document Processing System, Electronic Management System, and Design Division.

ISD-08 **Service Center Support System**: Includes projects that provide the foundation for other Service Center TSM projects.

INTERNAL REVENUE SERVICE
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ISD-09 **Corporate Files On-Line**: Includes projects for Corporate Files On-Line, Corporate Accounts Processing System, Workload Management System, Security and Communications System, and Automated Inventory Control System

ISD-10 **Corporate Systems Modernization and Transition**: A project to implement TSM-driven changes in the Detroit and Martinsburg Computing Centers.

ISD-14 **Service Center Recognition/Image Processing**: A project to replace the two existing non-compatible systems at each Service Center with one integrated system.

ISM-10 **Communications Modernization**: Includes projects to complete installation of the AMA System, cover services received through the Consolidated Data Network, and meet other TSM data communications requirements.

R-06 **Full Utilization/Electronic Filing System**: Includes projects for the Electronic Filing System and TeleFile.

United States General Accounting Office

GAO

Report to the Congress

June 1993

FINANCIAL AUDIT

Examination of Customs' Fiscal Year 1992 Financial Statements

GAO/AIMD-93-3

GAO

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-252376

June 30, 1993

To the President of the Senate and the
Speaker of the House of Representatives

This report presents the results of our efforts to audit the Principal Financial Statements of the U.S. Customs Service for fiscal year 1992. As part of this effort, we evaluated Customs' internal controls and its compliance with laws and regulations related to the financial statements. Pursuant to the Chief Financial Officers Act of 1990 (Public Law 101-576), Customs was required to prepare agencywide financial statements for fiscal year 1992 and have them audited. As authorized by the act, we attempted to perform an audit of these statements.

We were unable to express an opinion on the reliability of the fiscal year 1992 Principal Financial Statements of Customs because of the lack of reliable financial information, inadequate financial systems and processes, and its ineffective internal control structure.

In addition, we found that Customs' internal controls did not effectively safeguard assets, provide a reasonable basis for determining material compliance with relevant laws and regulations, and assure that there were no material misstatements in the Principal Financial Statements. However, we were unable to test all significant controls due to limited supporting information.

Further, we found no instances of material noncompliance with laws and regulations during fiscal year 1992.

We are sending copies of this report to the Commissioner of Customs; the Secretary of the Treasury; the Director of the Office of Management and Budget; the Chairmen and Ranking Minority Members of the Senate Committee on Governmental Affairs, the Senate Committee on Finance, the House Committee on Government Operations, the House Committee on Ways and Means, the Subcommittee on Commerce, Consumer and

Monetary Affairs, House Committee on Government Operations, the Subcommittee on Oversight, House Committee on Ways and Means; and other interested parties. Copies will be made available to others upon request.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

Contents

Abbreviations

ACS	Automated Commercial System
ADP	automated data processing
CFO	Chief Financial Officers Act
FMFIA	Federal Managers' Financial Integrity Act
JFMIP	Joint Financial Management Improvement Program
OMB	Office of Management and Budget

GAO

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-252376

June 30, 1993

To the Commissioner of the Customs Service

In accordance with the Chief Financial Officers (CFO) Act of 1990, the United States Customs Service prepared the accompanying consolidated financial statements (Principal Statements) for the fiscal year ended September 30, 1992. With reported collections of over $20 billion for fiscal year 1992, Customs is second only to the Internal Revenue Service in terms of federal revenues. Historically, Customs has filed unaudited financial information with the Department of the Treasury; however, the fiscal year ended September 30, 1992, was the first year for which Customs prepared a comprehensive set of Principal Statements that were subject to an audit. As authorized by the CFO Act, we elected to perform the audit of these statements. Customs fully cooperated with us and has made progress towards developing reliable information.

The results of our audit are summarized as follows:

- We were unable to express an opinion on the reliability of the fiscal year 1992 Principal Statements of Customs because of the lack of reliable financial information, inadequate financial systems and processes, and its ineffective internal control structure. Further, we concluded that important financial management information reported by Customs internally for management purposes and externally to the Congress, the Office of Management and Budget, and others was also based on incomplete or unreliable data.
- In our opinion, internal controls were not properly designed and implemented to effectively safeguard assets, provide a reasonable basis for determining material compliance with laws governing the use of budget authority and other laws and regulations, and assure that there were no material misstatements in the Principal Statements. However, we were unable to evaluate and test all significant internal controls due to limited supporting information.
- We were also unable to give any assurance on the information contained in the Overview to the Principal Statements and Supplemental Financial and Management Information because this information came from many of the same financial management systems and were subject to the same poor internal control structure.
- Our tests for compliance with selected provisions of laws and regulations disclosed no material instances of noncompliance.

Customs faces major challenges in developing meaningful and reliable financial management information and in establishing a sound internal control structure, as envisioned by the CFO Act. Customs' officials have expressed their commitment to these goals, and recognize that a significant and sustained commitment by Customs' management, particularly by the CFO and his staff, will be required. Acting on this commitment, Customs has implemented corrective actions or begun to correct problems noted during the financial audit.

Significant Matters

Our audit has identified a number of critical financial management problems that require attention, and we therefore believe that there is a high potential return on a greater investment in the financial management function. For years, until the passage of the CFO Act, Customs lacked financial management leadership with sufficient expertise, responsibility, and authority to ensure that its financial systems, processes, and internal controls fully supported Customs' financial information needs. Over time, this lack of leadership resulted in financial management systems and processes that were unable to provide critical and reliable financial information. Certain key internal controls were not established or were not followed to ensure that data entered, processed, summarized, and reported reflected Customs' actual operations. These problems presented substantial challenges to Customs in preparing these Principal Statements, some were met and others were not.

We found that Customs had material weaknesses in internal controls over many significant areas which could lead to (1) material loss of assets, (2) noncompliance with laws and regulations, and/or (3) material misstatements in the Principal Statements. The critical financial management problems that require attention are summarized below. Details will be communicated along with our recommendations for improvements in separate reports.

Financial Reporting

Customs' core financial systems did not provide complete and accurate information that could be used to prepare its Principal Statements. To prepare them, Customs and its outside contractor performed extensive work to construct the reported statement balances and related support from available information. In many instances, these efforts were not successful. In some instances we could not test information due to the lack of underlying support and, in other instances, the tested supporting information was found to be unreliable.

In preparing its financial statements as of September 30, 1992, Customs made over 180 adjusting entries, amounting to billions of dollars, to its accounting records as of September 30, 1992. We found that Customs could not support or explain many of these entries and some of the balances in the statements were forced. For example, neither the core accounting records nor the subsidiary records supported Customs' reported operating net financial position of about $1.3 billion; this figure was derived to force the Consolidated Statement of Financial Position to balance. Such forced amounts diminish the credibility of the reported information and demonstrate the need for the discipline and accountability imposed by financial statement audits to provide the Congress and other decisionmakers with reliable information.

We also found several instances where Customs' financial statements and related notes did not adequately disclose significant information.

- Customs did not fully disclose its historical experience on seizures that were ultimately returned to the owner and the related reasons.
- Customs did not disclose that it had 28 aircraft on loan from the U.S. military valued at about $142 million, that it is generally liable for damage or loss of loaned aircraft, and that it had incurred such charges in the past.
- Customs materially misstated the amount of revenues reported as allocated to the Department of Agriculture in its Consolidated Statement of Operations and Changes in Net Position. Customs reported allocated revenues to Agriculture of only $41 million; however, Public law 74-320 states that 30 percent of the $18.3 billion of duties collected should be allocated to Agriculture. Thus, about $5.5 billion should have been presented on the statement as allocated to Agriculture.
- Customs did not fully disclose in its commitments and contingencies note an amount of probable costs—estimated by its general counsel at more than $100 million—expected to be paid either from the Judgment Fund or from the Customs appropriation for refunds and drawbacks.

Finally, Customs did not report in its financial statements actual operating expenses by budget program, as required by the Office of Management and Budget (OMB). Because Customs did not have a cost system or a reasonable basis by which to provide such information, it reported operating expenses based on object classifications. We found in some cases that Customs used the wrong object classification to designate its expenses and cannot properly separate Customs expenses from interagency expenses. Thus, when this accounting information is summarized and reported, the Congress and other users do not have an accurate picture of where Customs spent its $1.46 billion in appropriations.

Custodial Accounts Receivable

As of September 30, 1992, Customs reported custodial accounts receivable of approximately $828 million which represented about 74 percent of the custodial assets that Customs held and was managing on behalf of the federal government. This amount included gross receivables of about $901 million, less an allowance for uncollectible accounts of $73 million. Customs' internal controls over accounts receivable were so poor that we could not gain assurance that all valid receivables were included in its reported amounts. Further, Customs' accounts receivable, as of September 30, 1992, did not include certain valid receivables; included some receivables at a net amount instead of gross; and in some instances included receivables which could not be supported. For example, the reported $901 million in gross accounts receivable included only $26 million for fines and penalties and excluded an indeterminate amount of fines and penalties cases. Customs' records did not show what amount was owed for these cases as of September 30, 1992. These misstatements distort gross receivables owed to Customs, as well as Customs' expected collection experience.

Also, Customs' methodology for estimating the collectibility of its receivables was unreliable and resulted in a significant misstatement of accounts receivable. Our tests showed that Customs' methodology was flawed because it considered primarily historical collection experience but did not consider the debtor's current ability to pay. We applied a methodology that included an assessment of the debtor's ability to pay to a sample of valid receivables as of June 30, 1992, of $403 million, which included gross fines and penalties receivables. We also applied Customs' methodology to the same accounts. Our methodology showed that an additional $41 million would likely not be collected.

We also found that detailed records of who owed Customs were not routinely reconciled nor updated in a timely manner. In addition, the records included debtors that did not owe Customs and excluded some that did. The problems were particularly evident in receivables resulting from fines and penalties and supplemental duty assessments. Consequently, Customs did not have an accurate record of who owed it money, or how much, for two of its largest accounts receivable categories. In addition, Customs' efforts to collect what was owed were compromised by missing documentation needed to support the amounts owed. Further, its ability to collect amounts due the U.S. government was also limited by

- delayed final determination of Customs duties—in many cases more than 1 year after the release of the imported merchandise;
- lack of controls to assure that bonding requirements for importers were sufficient to protect against their failure to pay;
- long delays in processing supplemental duty bills protested by importers; and
- failure to maintain adequate control over documents needed to collect balances due and inadequate follow-up on amounts due.

As a result of our audit, Customs plans to change how it determines the accounts receivable balance for September 30, 1993. Additionally, Customs has begun to modify its methodology for estimating collectibility. Customs recognizes the challenge it faces in collecting its receivables and has begun efforts to improve its collection practices. Correcting these problems will be difficult because Customs does not have financial management systems in place that provide current and accurate information on the status of its receivables.

Because of the severity of the problems that must be dealt with, it will take a substantive effort by Customs' management before it has reliable information with which to monitor and evaluate its performance in collecting receivables or determining how much the federal government is owed and can reasonably expect to collect.

Seized Property

As part of its enforcement duties, Customs seizes property[1] including cash, luxury automobiles, jewelry, illegal drugs, firearms, and other valuable or potentially dangerous property. Although Customs had established policies and procedures to assure proper accountability and stewardship of these items, it did not always follow them. Internal control weaknesses were evident throughout the seized property process, from the time property is first seized until it is disposed of. Opportunities for these goods to be stolen or misappropriated without detection were pervasive and

[1]We have previously reported on various issues regarding seized/forfeited assets. Such reports include Asset Forfeiture Programs (GAO/HR-93-17, December 1992); Asset Forfeiture: Customs Reports Improved Controls Over Sales of Forfeited Property (GAO/GGD-91-127, September 25, 1991); and Oversight Hearings on Asset Forfeiture Programs (GAO/T-GGD-90-56, July 24, 1990).

such occurrences could result in financial loss to the government or danger to the general public.

In preparing its financial statements, Customs made net adjustments of about $281 million to its fiscal year 1992 seizures amount and net adjustments of $52 million to its September 30, 1992 seized property inventory. However, Customs could not provide us with support for the adjustments. After making the adjustments, Customs reported $542 million in seizures during fiscal year 1992 and an ending balance of $489 million in seized property in the notes to its Principal Statements as of September 30, 1992.

Customs' records to control, manage, and report seized property were incomplete and inaccurate. Specifically, these records (1) did not include large quantities of seized property, (2) showed incorrect location data for some items, (3) included erroneous values, such as those for counterfeit items, and (4) included seizures and forfeitures that occurred in another fiscal year. For example, we found several instances of drugs that were on hand that were not in the seized property records. Also, our analysis of the value of property seized in fiscal year 1992, as recorded in the seized property records, showed that Customs overstated this amount by about $138 million. This amount was overstated because Customs included items for which it never took possession. In addition, our analysis of about half of the recorded value of fiscal year 1992 seizures for which Customs took possession and seized property on hand as of September 30, 1992, showed these amounts to be overvalued by approximately $217 million and $113 million, respectively.

With regard to safeguarding seized property, Customs often used weak and inconsistent procedures. We noted such specific problems as

- delayed transfer of confiscated property from seizing officers to custodians;
- seized drugs not being properly weighed and tested;
- delayed deposits of cash or deposits in non-Treasury accounts with insufficient insurance or collateral protection; and
- storage facilities not properly protected, for example, open physical access, no security cameras, and insufficient control over access by personnel.

Given the wide-range of control weaknesses noted and the significant errors that we found, Customs will have to make a substantive effort to ensure that seized property records are accurate and complete.

Property

Customs is responsible for managing and reporting its property, plant, and equipment, which is valued in the financial statements at $710 million. Approximately 85 percent of this amount consisted of equipment, such as aircraft, vehicles, and vessels. Some of this equipment contains highly sensitive detection and surveillance items used by Customs in its drug enforcement activities.

The values for these assets were based on property and accounting records that were unreliable, and the assets themselves were not adequately safeguarded against theft or misappropriation. We found that Customs (1) was unable to reconcile its accounting records and related detailed property subsidiary records to ensure that all property items were properly accounted for and valued, (2) did not perform physical inventories of all nonequipment items and performed ineffective physical inventories of equipment, and (3) was unable to support the values assigned to property, primarily because, for many items, appropriate procurement documents were not available and, in some instances, Customs used unrealistic estimates. For example, Customs could not provide documentation to support values totaling over $9 million assigned to 335 of the 706 items we tested. In addition, as a result of our analysis of all property records in the property system, we found 735 instances in which the assigned values for equipment items appeared to be estimates.

Further, Customs' property records (1) did not include all property items on hand, (2) included lost or disposed property items, (3) included property with erroneous or unsupported values, and (4) did not include all costs related to developing software in-house, which can be worth millions of dollars.

Customs has taken steps towards resolving long-standing problems in its property records and is planning additional efforts. For instance, as part of Customs' Office of Information Management Fiscal Year 1993 Project Plan, Customs plans to determine the costs for all existing software that had been developed in-house and develop procedures to account for these costs for all ongoing activities.

Revenue

Customs relies to a great extent on importers/brokers to voluntarily report and assess the amount of duties, taxes, and fees owed on imported merchandise. We reviewed Customs' revenue processes from the time merchandise arrived at U.S. borders until it was entered into U.S. commerce for consumption. We found no significant internal controls to ensure that merchandise entering the United States was identified and the proper duty assessed. Due to vast quantities of import activity and a poor internal control environment, we could not reasonably test whether dutiable merchandise that entered the United States was identified and the proper duty assessed.

Based on our tests of individual revenue transactions, such as duties, taxes, and fees owed, and the collection and classification of amounts paid, we concluded that the reported $20.2 billion of total revenues approximates revenues collected from importers who voluntarily reported and paid amounts owed. However, because of the potential for goods to enter and not be identified, we cannot give any assurance that the reported $20.2 billion represents all revenues which Customs should have collected for fiscal year 1992.

Also, Customs is the initial source of information for international trade statistics on imports used in monitoring and formulating trade policy. Thus, to the extent that Customs' information may be in error, trade statistics could also be misstated. While Customs recognizes these weaknesses and has established a project to improve importer compliance and target inspections for trade enforcement purposes, it will take a significant effort to adequately address the broad scope of problems in this area.

Drawbacks

Customs makes refunds to claimants for 99 percent of duties paid, when the related imported merchandise is subsequently exported or destroyed. These refunds are known as drawbacks. Of the $775 million Customs reported as refunds and drawbacks expense, $496 million were drawback payments Customs made during fiscal year 1992.

We found serious control weaknesses at all stages of the drawback process. Customs did not (1) adequately assess the validity of a drawback claim and track the amount of drawback paid against an import entry, (2) establish sufficient review procedures to ensure that a claim was accurate, (3) ensure that required bonds were adequate, and (4) ensure that only authorized claimants received accelerated[2] drawback payments. These weaknesses create an environment where the federal government could lose millions of dollars.

As a result of Customs not having internal controls to prevent and detect duplicate or excessive drawback claims and the large volume of import documents associated with drawbacks, detailed testing was impractical. Customs reported 53,000 drawback claims in fiscal year 1992. Each claim may be associated with a number of separate entries. For example, one of the drawback claims in our limited sample had 957 associated entry summary documents. Because we were unable to test whether drawback payments made in fiscal year 1992 were valid and did not exceed 99 percent of the original duties paid, we cannot give assurance that the reported $496 million represented valid claims.

Customs did not have an automated system that (1) links drawback payments to entry summaries and (2) maintains information about a claimant's filing history. The inadequate systems and control weaknesses discussed above increase Customs' vulnerability to lost federal funds. Although Customs had plans to revise the drawback and revenue systems, the drawback revisions were given a low priority. Until these weaknesses are corrected, the potential for fraudulent and other invalid payments occurring will continue.

Accounts Payable

Customs had no assurance that reported accounts payable of $73 million as of September 30, 1992, included amounts actually owed. Customs' financial management systems were designed to record accounts payable only when both the goods or services and an invoice had been received. Therefore, liabilities were routinely not recorded for goods or services received until an invoice had been received and processed.

At year-end, Customs used special procedures to identify and record accounts payable for which goods and services had been delivered as of September 30, 1992, but the invoice had not yet been received. However, Customs could not provide information necessary for us to test whether all payables as of September 30, 1992 had been identified. Further, our limited testing of payables Customs identified found that the reported amount may be overstated due to amounts being recorded for goods and services not received in fiscal year 1992.

[2] Accelerated drawback payments are made to authorized claimants prior to Customs reviewing and verifying the validity and accuracy of the claim. Nonaccelerated claims are paid after Customs reviews them. Therefore, accelerated payments represent a greater risk than nonaccelerated payments.

Also, we found that Customs' monitoring controls over contracts were weak. Specifically, we found instances where Customs' contracting officers and technical representatives approved payments on contracts without verifying the validity of the charges by comparing them to the goods or services received. This lack of verification makes Customs vulnerable to fraudulent or overstated charges being submitted and paid without detection.

Intragovernmental Receivables and Reimbursable Services Retained

Improper accounting procedures and weak controls over interagency agreements[3] resulted in Customs misstating amounts owed and reimbursed by other government agencies. We could not determine whether the reported $72 million in intragovernmental receivables nor the related $307 million in reported reimbursable services and user fees retained were correct or reported in the period the goods or services were provided to the other agencies.

We found that Customs did not (1) follow its own guidelines for recording interagency agreements, (2) maintain records to support amounts reimbursed by other agencies, (3) properly record and report its available budgetary resources[4] with respect to interagency agreements, and (4) bill and collect amounts owed from other agencies based on delivered goods or services.

Customs recognized that it had problems accounting for interagency agreements and took steps to correct them. Customs hired an accounting firm to perform a detailed review of certain interagency agreements to determine if amounts owed were appropriate based on what portion of the goods or services called for in the agreement had been provided. This review resulted in a $96 million downward adjustment to the intragovernmental receivables and reimbursable services retained, leaving reported balances of $72 million and $307 million, respectively. However, Customs could not identify how much of the $96 million pertained to fiscal year 1992, and the accounting firm agreed that a portion of the adjustment was attributable to prior years. Thus, the reported balance for

[3]Interagency agreements provide a mechanism for an agency needing supplies or services to obtain them from another agency (the servicing agency). Generally, the requesting agency reimburses the servicing agency for the cost of providing the goods and/or services.

[4]OMB apportions the amount of budgetary authority available for interagency agreements at the beginning of each fiscal year based on an estimate of the total value of agreements in which Customs will participate. Upon signing an agreement (as the servicing agency) Customs has budgetary resources available for obligations needed to fulfill the agreement. Certain budgetary resources that remain unobligated at year-end will be carried over to the next year.

reimbursable services and user fees retained is likely to be understated to the extent that it was reduced in fiscal year 1992 for amounts that related to earlier years.

In addition, overstatement of certain amounts owed by other agencies to Customs resulted in Customs reporting inflated unobligated budget resources. These amounts carry forward into future years and appear as budget authority available to cover future spending by Customs. Consequently, Customs' improper budgetary accounting for these interagency agreements caused amounts reported to its program managers, OMB, and others as available budget resources to be incorrect.

Unliquidated Obligations

Under federal accounting requirements, obligations are initially recorded based on a contract or other formal order for the acquisition of goods and services. During the course of the year, obligations are to be reduced (liquidated) upon receipt of the goods or services ordered. At this point, budget authority is said to be expended. When budget authority is expended, the related obligation is liquidated and the appropriation is charged with the actual costs of items received.[5]

Customs did not ensure that (1) obligation balances were reduced for the cost of goods and services received, (2) obligations incurred reflected reasonable estimates of spending levels, and (3) unneeded obligations were deobligated in a timely manner. We also found that obligations were often misclassified in Customs' accounting records. Customs' failure to record expended appropriations or deobligate funds in a timely manner misstated Customs' funding needs. Consequently, Customs managers and other decisionmakers were not provided with accurate information. In addition, it eliminated the potential for these funds to be reprogrammed within its appropriations.

Customs' reported unliquidated obligations of $361 million were approximately 25 percent of its fiscal year 1992 appropriation.[6] Of the 102 unliquidated obligation balances we reviewed, approximately 42 percent, or $83 million of the total value of the sample, should have been deobligated or expended. In addition, Customs could not provide support for 17 unliquidated obligation balances totaling $7.3 million.

[5]Obligations remain available for expenditure until the related goods and/or services have been received.

[6]This includes Customs' general and special funds which can be used to fund its operations.

An indication of Customs' failure to promptly expend funds upon receipt of goods or services was further corroborated when Customs identified over $70 million of unrecorded accounts payable in conducting its year-end procedures. The scope of our work on unliquidated obligations, as in accounts payable, was limited due to the lack of underlying support needed to determine that accounts payable were properly stated. Therefore, we could not affirm that the reported balance was properly stated.

FMFIA

Customs did not disclose the overall severity of its internal control and accounting system weaknesses in its report to Treasury on its conformance with FMFIA objectives. Without adequate disclosure, users of the FMFIA report will not be aware of the extent of Customs' weaknesses and the efforts needed to correct them. We found material weaknesses that Customs either did not include or did not adequately disclose in its fiscal year 1992 FMFIA report. For example, while Customs reported that its accounting system cannot properly age and estimate collectibility of accounts receivable, it did not disclose that its systems contain incomplete and inaccurate receivables information. Also, Customs reported that the interface between its accounting system and detailed property subsidiary records is inadequate and inconsistent but did not disclose the extent of the weaknesses in controls to ensure that information maintained in these records was accurate.

In addition, some previously identified material weaknesses that Customs reported as corrected, including accrual accounting for liabilities and accountability over seized currency, still existed because Customs did not ensure that corrective actions were effective. These weaknesses seriously eroded Customs' ability to safeguard, manage, and control its import revenues and operating expenditures.

Chief Financial Officer's Role

Management of the Customs Service is one of 17 program areas identified by us as being at high risk to waste, fraud, abuse and mismanagement.[7] For years Customs did not have a management structure that included a Chief Financial Officer (CFO) with the necessary credentials nor authority of the sort now provided by the CFO Act. The absence of an effective CFO structure in Customs resulted in (1) automated data processing (ADP) systems that were developed with little or no consideration given to

[7] Managing the Customs Service (GAO/HR-93-14, December 1992).

reporting financial information and (2) in many instances, no policies or procedures designed to ensure that reported information was reliable.

Over the last 2 years, since the passage of the CFO Act, Customs has put in place a CFO structure and given the CFO the authority and responsibility necessary to begin to correct many of the problems identified in our audit. However, the depth and number of the problems found is such that it will take a concerted effort and sustained commitment by Customs' CFO and senior management to correct them. In this same light, the success of Customs' ongoing ADP system modernization efforts, and particularly its Automated Commercial System (ACS) redesign effort, will be critical to improving Customs' financial management systems and internal control structure. It will take the combined impact of the CFO structure and successful implementation of its system modernization efforts to enable Customs to produce useful information on its operations that decisionmakers, such as the Congress and the agency's senior management, can rely on.

Objectives, Scope, and Methodology

Management is responsible for

- preparing annual financial statements in conformity with applicable accounting principles,
- establishing and maintaining internal controls and systems to provide reasonable assurance that the broad control objectives of FMFIA are met, and
- complying with applicable laws and regulations.

We are responsible for obtaining reasonable assurance about whether (1) the Principal Statements are reliable (free of material misstatements and presented fairly in conformity with applicable accounting principles) and (2) relevant internal controls are in place and operating effectively. We are also responsible for testing compliance with selected provisions of laws and regulations and for performing limited procedures with respect to certain other information appearing in the annual financial statements.

In order to fulfill these responsibilities, we attempted to

- examine, on a test basis, evidence supporting the amounts and disclosures in the Principal Statements;
- assess the accounting principles used and significant estimates made by management;

- consider compliance with the process required by FMFIA for evaluating and reporting on internal control and accounting systems;
- evaluate the overall presentation of the Principal Statements;
- evaluate and test relevant internal controls which encompassed the following areas:
  - cash receipts and disbursements,
  - treasury funds,
  - accounts receivable,
  - accounts payable,
  - seized assets,
  - property, equipment, and inventory, and
  - budget; and
- test compliance with selected provisions of the following laws and regulations:
  - Antideficiency Act,
  - Chief Financial Officers Act of 1990 (Public Law 101-576),
  - Federal Managers' Financial Integrity Act of 1982 (Public Law 97-255),
  - National Defense Authorization Act for Fiscal Year 1991 (Public Law 101-510),
  - Fair Labor Standards Act of 1938,
  - Civil Service Retirement Act of 1930,
  - Civil Service Reform Act of 1978 (Public Law 95-454),
  - Federal Employees' Compensation Act,
  - Federal Employees' Group Life Insurance Act of 1980 (Public Law 96-427),
  - Federal Employees' Health Benefits Act of 1959 (Public Law 86-382),
  - Prompt Payment Act (Public Law 97-177),
  - Federal Acquisition Regulations,
  - Title 19, United States Code, and
  - Title 19, Code of Federal Regulations.

As previously noted, we were unable to obtain reasonable assurance about whether the Principal Statements were reliable (free of material misstatement and presented fairly in conformity with applicable accounting principles) because Customs' financial systems and processes were inadequate, its internal control structure was ineffective, and Customs lacked reliable financial information. Also, we did not evaluate all internal controls relevant to operating objectives as broadly defined in FMFIA, such as controls relevant to preparing statistical reports and ensuring efficient operations. We limited our work to accounting and other controls to achieve the objectives in our opinion on internal controls.

Except for the limitations on the scope of our work described above, our work was done in accordance with generally accepted government auditing standards and OMB Bulletin 93-06, "Audit Requirements for Federal Financial Statements."

Charles A. Bowsher
Comptroller General
of the United States

May 28, 1993

Financial Statements

Overview of Financial Entity

LETTER FROM THE COMMISSIONER

In the last 200 years, the mission of the U.S. Customs Service has expanded from a focus on collection of revenue to today's role as the Nation's primary border enforcement agency responsible for enforcing laws and regulations governing international traffic and trade. Customs provides a broad spectrum of commercial, enforcement, and inspection services to the American public. Every year, Customs processes hundreds of millions of passengers, millions of shipments of merchandise (valued at over $500 billion), carriers, and vehicles, in a swift, efficient manner, while at the same time inhibiting the influx of contraband materials, pirated copies of protected merchandise, and articles dangerous to the general public. In addition, Customs acts to prevent the shipping abroad of dangerous and hazardous materials, weapons, and high technology where prohibited by law. The enforcement role of Customs in the economy and in the areas of national health and welfare has continued to grow.

The challenges we face in the near future are great. In the last decade, world economic growth and the increased interdependence of the global economy have accelerated trade and rapidly increased our workloads. The risks of prohibited goods entering our shores undetected are growing, while trafficking in illicit narcotics and associated money laundering activities continue as a major concern. In addition to these mission challenges, however, another major concern is the integrity and accuracy of the financial systems involved in administering our programs and the adequacy of the procedures in place to prevent fraud, waste, or mismanagement of public funds. The Chief Financial Officer's (CFO) Act of 1990 places new emphasis on government-wide efforts to promote better financial management and maximize the effective use of limited resources. Our actions to implement CFO requirements have added impetus to the far-ranging financial management improvements begun at Customs in the last several years.

I have instituted an integrated planning process at the Customs Service to measure our successes and chart our future. The preparation of the current year CFO Report has presented an opportunity to take stock of how well we are safeguarding and accounting for the resources provided to implement our programs. The report provides an overview of our goals and functions as well as a clear statement of how we are using program resources. As required by the CFO reporting process, special emphasis has been placed on presentation of performance indicators which relate our achievements to the resources expended.

The report also points to significant improvement in our cash management and funds control processes, in our accounting and reporting of revenues, and in the reconciliation of Customs collections and deposits. Improved cost information has become available through a new payroll system. This information will be enhanced through implementation of a cost accounting system being developed in FY 1993. This year, Customs implemented a new core financial system and will be integrating ancillary systems with it as part of the ongoing development of Customs Asset Information Management System. Customs is also beginning the redesign and enhancement of the financial aspects of its commercial and revenue systems (the Automated Commercial System). We have greatly expanded the scope and intensity of efforts to improve management and internal controls within the agency. Taken together, these initiatives are resulting in coherent, comprehensive, and effective procedures to fully utilize and account for Customs resources. All of these efforts are in keeping with what I perceive to be the ultimate goal of the CFO Act.

I am proud of Customs accomplishments in carrying out its mission of trade enforcement, trade administration, and narcotics enforcement. I am also proud of our efforts to create an atmosphere of improved financial management and I believe our Annual CFO Report is an excellent vehicle to communicate our continued progress in both areas.

Michael H. Lane
Acting Commissioner
U.S. Customs Service

INTRODUCTION

IMPLEMENTING THE CFO ACT OF 1990

The Chief Financial Officers (CFO) Act of 1990 represents the most far-reaching financial legislation in nearly 40 years. Customs is one of the pilot agencies for financial statement preparation and audit by the U.S. General Accounting Office (GAO). Customs has fully realized the need for greater management attention to financial management and recognized current problems, which we have begun to address. The financial statements are intended to be of value to users in making economic, social, and political decisions and in assessing our accountability.

In recognition of the need to be held accountable to our customers and stakeholders and the requirements of the CFO Act of 1990, we have prepared comprehensive financial statements with footnotes for FY 1992. The statements have then been audited by GAO. In preparing the formats and footnote content of the financial statements, professional guidance was obtained from a variety of sources. Further clarification on financial statement presentation is expected as the Federal Accounting Standards Advisory Board (FASAB) addresses issues unique to the Federal Government.

The Government Accounting Standards Board, Concepts Statement Number 1, states that "Governmental accountability is based on the belief that the taxpayer has a right to know, a right to receive openly declared facts that may lead to public debate by taxpayers and their elected representatives" (paragraph 56). Accountability includes a requirement to render an account or explain ones actions to someone else who has the authority to assess performance and to make judgement and take action.

The impact of the CFO review and financial statement preparation process on Customs goes beyond the finance function. Customs has begun to look carefully at the underlying financial support structure throughout its organization. Using CFO audit findings to compliment already existing cost-benefit analyses, Customs is now beginning to integrate its financial management decisions with decisions concerning its operations.

CUSTOMS OVERVIEW

CUSTOMS PROFILE

The U.S. Customs Service is formally charged with the collection and protection of the revenue and with enforcement of "more than 600 laws for 60 agencies." Its primary responsibility, however, is more clearly understood as enforcing the laws governing the flow of merchandise or commerce across the borders of the United States. In doing this, the U.S. Customs Service plays a key role in enforcing the provisions of two major government-wide programs: the U.S. Trade Program and the U.S. Narcotics Enforcement Program. Customs effectiveness, therefore, is often viewed in terms of its effectiveness in contributing to the success of these two larger programs.

Trade Enforcement and Administration

The Trade Program is made up of both import and export trade efforts. On the import side, U.S. policy on trade, and Customs role in it, evolved from use of a tariff for revenue or protectionist purposes, to a role of complex trade enforcement. At one time revenues produced by tariffs provided about 90 percent of all federal receipts. Today, these revenues account for less than two percent. As a result, the main focus of Customs efforts in this mission area have changed from revenue collection to trade enforcement.

Today's trade program is a product of complex international trade negotiations. Customs role in carrying out U.S. import trade policy is primarily that of enforcing compliance with trade policy requirements. Most of these requirements have to do with protection of the public, labor, and domestic industry as expressed in trade legislation.

Customs primary role in the U.S. import trade program is mandated in the Tariff Act of 1930 as amended. Customs responsibilities include enforcing intellectual property rights, tariff/monetary controls on imports, numerical provisions on imports, admissibility provisions, e.g., marking, labeling and other admissibility requirements, and providing accurate statistics (import and export) to be used in monitoring and formulating trade policy.

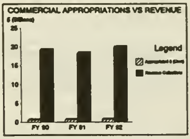
By enforcing these provisions, Customs serves as an implementing agent of U.S. trade policy and contributes to the objectives of protecting U.S. industry, agriculture and labor from unfair competition, protecting the American public from the entrance of harmful products into the marketplace, and providing adequate statistical data to assist in the monitoring and formulation of future trade policy.

One of the major challenges for Customs in the 1990's is to achieve an effective trade enforcement strategy. Predatory and unfair trade practices of foreign competition have put domestic companies in an unfair competitive position. In response, Customs has established a new trade enforcement strategy which includes a servicewide trade enforcement vision, identifying national trade enforcement priorities. Agreed upon priorities are needed to combat potential abuse of trade agreements such as trans-shipment and marking violations; evasion of antidumping and countervailing duties; dangers to public health and safety; violation of quotas; import of articles produced by forced labor, loss of revenue through improper valuation, and infringement of intellectual property rights. The new Customs strategy will improve targeting of such practices through development and refinement of automated systems to identify high-risk countries, transactions, and commodities, and will integrate trade information and statistics needed for analysis.

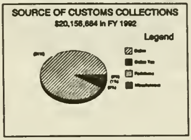
To better protect industry and the American public, Customs has launched a selectivity redesign project. By improving importer compliance, Customs will help ensure that domestic industries are given the opportunity to compete fairly in the marketplace. The selectivity redesign program seeks to measure and improve compliance with U.S. regulations on an industry-by-industry basis. When fully implemented, this system will help determine trade enforcement strategies.

In fulfilling its enforcement responsibilities, Customs also seeks to facilitate and minimize interference with the normal flow of legitimate trade. Finally, although revenue collection may no longer be Customs most important function, the Customs Service continues to collect, through the tariff and related fees, approximately $20 billion of Federal revenue annually. In FY 1992, Customs was the second largest producer of revenue for the Federal Government. It collected approximately $20 billion in duties, taxes, and fees while receiving only $759 million in appropriated funds for merchandise processing and trade fraud prevention, often labeled "commercial activities." Revenue collected by Customs is more than 26 times these Salary and Expenses (S&E) Account funds received for its commercial activities.

The largest single source of Customs collections was Customs duties which totaled $18.31 billion



in 1992. In addition, Customs collected $1.082 billion in IRS taxes, $166 million in forfeited currency and property, and $597 million in other miscellaneous revenue.



On the export side of U. S. trade programs, Customs role can be viewed as two functions: export promotion and export control. The first has involved providing Customs expertise to the Office of the U.S. Trade Representative regarding foreign customs barriers to export market penetration. On the export control side, Customs is involved along with other agencies in implementing controls over certain exports to protect national security, further foreign policy, or prevent excessive drain of scarce materials.

Narcotics Enforcement

In the early 1900's, narcotics control fell under the general trade category of admissibility or non-admissibility of a prohibited controlled substance. A totally separate program has evolved due to the complexity of modern day drug usage problems.

The current federal strategy emphasizes six major elements: international cooperation, community law enforcement, interdiction and disruption of traffickers' efforts, education and prevention, detoxification and treatment, and research.

Customs primary role in the overall Federal strategy centers around the strategy elements of interdiction and disruption of traffickers' efforts and increased international cooperation. Customs is also involved in the training of foreign nationals as a part of the education element.

As the nation's primary border enforcement agency, Customs plays a major part in the attempt to prevent illegal drugs from entering the country. Customs seeks to do this by careful and selective inspection of imported merchandise, passengers, and carriers, as well as through major interdiction efforts at our nation's borders, using highly technical means of detecting and intercepting smugglers via air, land, and sea routes.

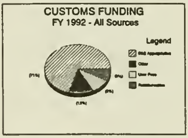
Customs has also taken on an extensive role in the investigation and disruption of smuggling activities through the conduct of undercover operations and through the disruption of the illegal cash flows and money laundering schemes that are the financial underpinning of the illegal drug business.

Customs works closely with other federal, state, and local narcotics agencies to reduce the availability of the supply of narcotics for distribution in the United States. Also, Customs seeks to disrupt and destroy major narcotic trafficking organizations to reduce the flow of narcotics from the point of origin.

Customs contribution to the training and education aspects of the national drug strategy revolve around our role as the primary international trainer of foreign Customs services. As the most technically advanced of the world's customs organizations, and the most aggressive in drug control, U.S. Customs is called upon to provide training to other customs services in inspection, control, and drug interdiction techniques.

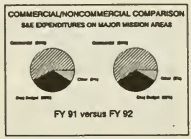
Customs Funding and Resource Use

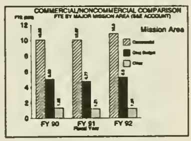
Since 1987, Customs has collected user fees from passengers, carriers, and goods entering the country and is permitted to use a portion of these fees to offset the cost of commercial operations.



Total funding from all sources for Customs operations was $1.794 billion in FY 1992, as shown above, and is provided by six different appropriations and reimbursements to these appropriations. The Salaries and Expenses Appropriation provided $1.265 billion in FY 1992 for Customs staffing and for many of its operations. User fees constituted $163.4 million and reimbursables approximately $144 million of the total. Finally, Congress also provided $221.6 million in other funds, primarily for activities associated with air and marine operations.

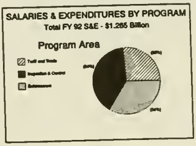
S&E funds were distributed across Customs two major mission areas in FY 1992 as follows. Approximately 60% of expenditures were spent on processing of merchandise entering the U.S. and trade enforcement (defined as commercial activities for budget purposes), while 32% went to drug enforcement. Eight percent was expended on non-commercial enforcement activities not related to drugs (for example, work to help other Federal or state agencies enforce laws in their area of authority). The commercial/non-commercial breakdown of S&E account funds in dollars is displayed below along with the distribution of FTE associated with this commercial/non-commercial allocation of S&E funds. The pattern in both cases is similar.





PROGRAM HIGHLIGHTS AND ANALYSIS OF PERFORMANCE IN MAJOR PROGRAM AREAS

Although Customs major mission areas are generally understood to be trade enforcement and narcotics interdiction, this mandate is carried out in a practical way by three major programs defined as Tariff and Trade, Inspection and Control, and Enforcement. Customs also has a separate appropriation for Operations and Maintenance. This area, involving operation and maintenance of aircraft, marine vessels, radar, and communications systems, is actually an integral part of Customs overall enforcement effort and is usually discussed in connection with the Enforcement Program. Since Customs budget is presented in terms of these major functional programs, the following program highlights will be in terms of these programs. An analysis in terms of these "budgetary" program areas reveals that 40% of S&E dollars are allocated to the Inspection and Control Program, 34% to the Enforcement Program, and 26% to the Tariff and Trade Program.

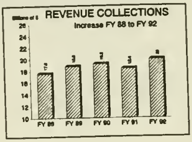


Tariff and Trade Program

Customs tariff and trade activities focus on two principal objectives: the expeditious administration and facilitation of trade, and the enforcement of numerous laws and regulations that affect U.S. trade and American industry. During this past year, Customs continued to confront not only growth in the number of commercial transactions, but also changing modes of transportation, more complex trade transactions, and an increasing number of administrative restrictions.

Trade Administration and Facilitation

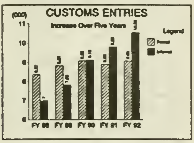
Customs trade administration responsibilities include: (1) collection of duties from imported merchandise; (2) ensuring uniformity in implementation of trade procedures; (3) accurate collection and reporting of import/export statistics; and (4) provision of efficient commercial services to the trade community.



During FY 1992, the Customs Service continued to process approximately $500 billion worth of imported merchandise across U.S.

borders. Collection of duties, fees, and taxes produced a total of $20.16 billion in revenue in FY 1992, and the trend in revenue has been up over the last five years.

This massive trade required the processing of tens of millions of transactions for entry of goods at the national seaports, airports, and land borders. The predominant measure of workload in the trade area is Customs entries filed for the admission of merchandise into the United States. An entry is made when the content and value of merchandise entering the country is legally defined and documented for purposes of determining admissibility and applicable duties or taxes. Informal entries are primarily distinguished from formal entries by the low dollar value of merchandise involved.



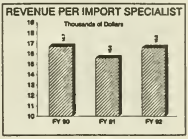
Another measure of the efficiency of Customs trade program operations is the return Customs is generating for each appropriated dollar spent on commercial operations, as measured by total revenue in relation to dollars appropriated for the commercial part of Customs mission ($759 million in FY 1992). During the period 1988 to 1990, the return per dollar rose 19%, and the current rate of return is approximately 26 dollars for each appropriated budget dollar allocated to commercial operations.

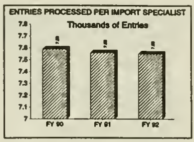
In order to improve the quality of service provided to the trade community, and to avoid becoming a "bottleneck" to the rapid movement of merchandise, Customs commercial systems have undergone continuous modernization and automation in recent years.

The Automated Commercial System (ACS) was developed to automate the hundreds of commercial processing tasks required for import entry and duty collection. An Automated Broker Interface (ABI) system now accounts for 90% of the Customs entries received from the trade community.

Customs has also developed automated manifest systems to expedite the transmission and review of cargo manifest information from both sea and air transport modes. "Line release," which is an automated system designed to track and expedite the release of high volume, low risk cargo previously reviewed by Customs, is also being used to expedite merchandise shipments.

With the increasing use of examination profiles and criteria, supported by automation, to selectively examine merchandise, Customs commercial programs are now designed to facilitate cargo and entry processing, while maintaining compliance with trade laws and regulations.





Customs has also been successfully pursuing the development of methods for the electronic transfer of information and funds, as well as a goal of achieving the paperless processing of as many of Customs transactions as possible.

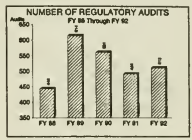
Trade Enforcement

Trade enforcement is the focus of Customs trade administration activities. In administering various trade provisions, Customs is relied upon to enforce and detect violations of these provisions.

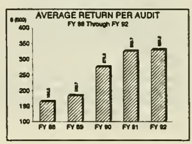
One of Customs primary trade enforcement responsibilities is the correct application and collection of tariffs and taxes on imported merchandise. The degree to which Customs properly carries out this function provides a measure of how well our protection of American industry is being carried out.

One Customs initiative to improve trade enforcement, while at the same time facilitating trade, is through the Regulatory Audit Program. This audit process focuses on examining the books and records of importing carriers, customhouse brokers, bonded warehouses, foreign trade zones, importers and other entities importing and exporting merchandise into and out of the United States.

Auditors use financial records to ensure compliance with U.S. trade laws, regulations and international agreements. Since its establishment in 1973, the Office of Regulatory Audit has completed more than 11,000 audits with total duty and tax recoveries in excess of $700 million.



On commercial fraud and national audits, auditors produce approximately $15 for every $1 in auditor costs. In addition to producing duties and taxes, audit work is now resulting in some of the largest penalties in the Customs Service's 200-year history. Major audits have resulted in company payments of $34 million and $18 million in individual cases.



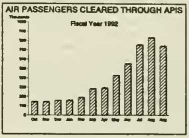
Inspection and Control Program

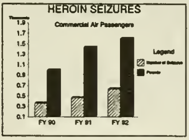
Customs inspectors are the first line of defense at our nation's ports in the drug war, in trade policy enforcement, and in consumer protection. In addition, they have become increasingly involved in export enforcement of licensed merchandise, illegal money movements, and the illegal export of stolen merchandise. In FY 1992, Customs inspectional work force cleared 47 million air, 392 million land, and 7 million sea passengers; processed nearly 21 million formal and informal entries; and cleared 10.3 million cargo containers, over 6 million trucks, 124 million passenger vehicles, 600,000 air carriers and 285,000 sea carriers.

Customs inspectors strive to handle this exceptional workload with increased efficiency, decreased intrusiveness, and enhanced enforcement effectiveness. They rely heavily on automation, new technology and selective techniques to meet these enforcement and facilitative needs. Customs is constantly developing and refining profiles of high-risk targets in order to focus on high-risk passengers and cargo. The remaining workload proceeds with minimal interference from Customs. We employ this philosophy of maximum efficiency and effectiveness - and minimum intrusiveness - in all our operational areas: passenger administration, cargo enforcement and control, narcotics and contraband enforcement, canine enforcement, and outbound enforcement.

Passenger Administration

In the passenger environment, this philosophy of maximum efficiency and effectiveness with minimal intrusion is embodied in the "Master Plan of the 1990's" concept. Due to a selective approach to passenger administration, Customs experienced no significant delays at our major airports last year and accomplished this without compromising enforcement responsibilities. The Master Plan has enabled Customs to handle peak passenger arrival periods more smoothly. The Advance Passenger Information System (APIS) also helps minimize passenger queues, while at the same time contributing to Customs enforcement efforts. APIS allows airlines to provide pre-arrival passenger information to Customs for prescreening purposes, providing more time to target high-risk passengers. Currently, 20% of air and 27% of sea passengers are screened through APIS. The charts illustrate the increase in passengers cleared through APIS and the results of Customs inspections of commercial air passengers.

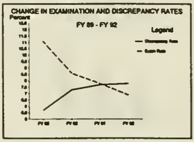




Another boost to Customs facilitative efforts in the passenger environment is the Customs and Trade Act of 1990. It authorizes Customs to hire inspectors from surplus user fee revenues. In FY 92, 171 inspectors were hired to improve service at the nation's airports, and approximately $2 million was allocated for part-time inspectors to support airport operations during peak arrival periods. These revenues also permit continued funding for 290 inspectors hired in FY 91. In addition to personnel, the Act permits Customs to use these funds to increase the application of technology at our airports.

Cargo Enforcement and Control

Customs philosophy of maximum effectiveness and minimum intrusiveness is evident most clearly in our cargo environment. Cargo Selectivity has heightened our ability to detect fraud, protect revenue, and facilitate trade. We are able to examine fewer entries and detect more discrepancies (marking, quota, and narcotics violations). During FY 92, 8 million entries were processed through Cargo Selectivity. Of those entries, only 6.9% were examined, and of those entries examined, 7.8% were found to have discrepancies.



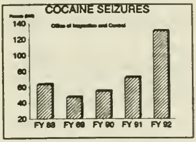
Selectivity is rendered useless if the effectiveness of the criteria used is not constantly evaluated. CFAST, the Cargo Facilitation and Selectivity Targetor, is a tool used to evaluate criteria effectiveness, determine the expected impact of new criteria, and create statistical reports on all discrepancies. In response to system changes, CFAST was revised in FY 92. In addition, Customs developed a new system, the Commercial Fraud Targetor, which analyzes discrepancies in order to prioritize examinations. As this system matures, it will improve our examination discrepancy ratio.

In the air and sea environment, Customs is relying more heavily now on the Automated Manifest System (AMS). Through AMS, carriers are able to transmit manifest information electronically to Customs, usually prior to carrier arrival. Today, 65% of all inbound ocean bills of lading are processed through Sea AMS. Due to extensive marketing efforts, Air AMS now includes 24 participants at 12 airports, and we have received letters of intent from six additional carriers. This increased from four participants in FY 1990 and ten participants in FY 1991.

Due to an agreement negotiated with the U.S. Postal Service, mail processing efficiency has increased tremendously. Customs was able to reduce parcel processing locations from 126 to 21. The Automated Mail Entry Writing System (MEWS) is now installed at 16 of those locations, representing automation of 99% of all dutiable mail entries. MEWS reduces protests and processing time and improves internal controls.

Narcotics and Contraband Interdiction

In FY 92, inspectors and canine enforcement officers seized 130,255 pounds of cocaine; 221,494 pounds of marijuana; 1,976 pounds of heroin; and 3,166 pounds of hashish. They also made inbound and outbound currency seizures totalling $81,346,409.

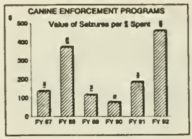


Targeting methods, such as the Container Cargo Targeting Information System, which identifies high-risk containers for examination, have greatly enhanced our narcotics enforcement abilities. In addition, we have initiated the development of a national narcotics targeting strategy which will maximize our resources by combining all merchandise data and intelligence into a single system.

Canine Enforcement Officer Program

Customs Canine Program is over 20 years old and is recognized as the finest training program of its type in the world. It is based on the use of dogs to detect narcotics smuggled into the country in cargo, conveyances, baggage and on passengers. This program is extremely effective and speeds up the processing of cargo and passengers.

Customs now has an authorized level of 446 teams, and over the years, the Canine Enforcement Training Center has trained thousands of teams for state, local, and foreign governments. In FY 92, the Canine Program, through "cold hits" and inspector referrals, made



5,530 seizures. Seizure results included: 109,950 pounds of cocaine; 161,351 pounds of marijuana; 168 pounds of heroin; and 2,749 pounds of hashish. In addition, $12.8 million in currency was seized. The teams returned approximately $459 for every dollar spent.

Export Control

Finally, Customs seeks to deter and intercept the illegal exportation of currency, technology, munitions items and other embargoed merchandise which are intended for export in violation of U.S. policies and law. Customs inspectional efforts focus on the exportation of proceeds from the illegal drug trade and, more recently, on stolen goods. Key areas affecting national security are also a high priority. These include illegal exports and/or diversions of missile technology, nuclear nonproliferation, chemical and biological warfare, and technological data transfer. Our efforts have resulted in: 862 currency seizures totalling $42.4 million; 689 seizures of high technology and munitions items valued at $52.6 million; 45 seizures and 24 arrests for violations of chemical precursors and essential chemicals export laws; and recovery of over 1,000 stolen vehicles.

Inspection and Control Issues and Problems

The Office of Inspection and Control is working diligently to develop better criteria for evaluating the effectiveness of its various programs. By the end of FY 93, all program managers will have identified the key elements needed to assess their programs. The availability of some or all of the information in a useful format will be an issue for each program. This will require an assessment of existing data collection mechanisms to determine if changes, additions, or deletions are required. Then data integration requirements will be identified, wherever possible, so that information can be collected and presented in an automated format.

An assessment of the Office of Inspection and Control's effectiveness in the enforcement arena will require more than data. Unlike private industry and some federal agency operations, Customs and other enforcement agencies are usually dealing with estimates of threat, or indirect measurements to infer the level of threat. Because of this, changes in individual performance indicators without analysis can be misleading. A decrease in cocaine seizures in one area, for example, could be the direct result of a deliberate attempt by a cartel to drive the price up and not a reduced level of effectiveness; or a decrease in inspector commercial textile seizures could be a result of a change in commercial import barriers.

Enforcement Program

The Customs Enforcement Program encompasses a wide range of activities and initiatives focused in four functional areas:

o Investigations of all violations of Customs and related laws and regulations, both domestic and foreign. Fraud, financial, smuggling, and strategic investigations are primary foci of Customs enforcement activity.

o Interdiction to deter and detect prohibited entry of contraband or other Customs or related violations through land, sea, and air operations.

o Enforcement support, including research and development and communications management. The R&D and Communications functions within the Office of Enforcement support not only that office but other offices within Customs as well.

o Intelligence support including the collection, analysis, and dissemination of strategic and tactical intelligence data for use by the operational elements of the Customs Service.

The broad strategies for the Enforcement Program are:

(1) To increase intelligence capacity, inter-agency cooperation, undercover operations, and applications of technology to investigative and interdiction programs.

(2) To assure comprehensive, information-based, integrated and coordinated investigative and interdiction programs, utilizing intelligence, formal case development, undercover operations, and a multi-disciplinary team approach.

(3) To monitor and evaluate program performance by office/location in terms of results, goals, and objectives versus resources expended. Consequent decisions about the distribution of people and assets take into consideration performance analyses, threat analyses, and geographic distinctions.

Investigative Programs

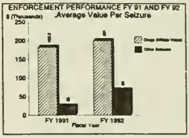
Investigative Programs consist primarily of four areas: financial, fraud, strategic, and smuggling investigations. The recent implementation of the direct line reporting structure now results in centralized direction and guidance to field offices on both investigative and organizational matters.

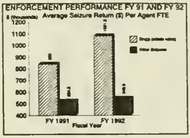
Numerous major investigations have been successfully completed and many are currently underway. These activities depend upon a well-trained staff, good working relationships with domestic and international counterparts, and the education and training of foreign counterparts and the trade community concerning Customs laws, regulations, and enforcement goals.
Numerous undercover operations have been conducted in various program areas. These have been supported by training agents as undercover operatives, providing Headquarters review and approval of proposed undercover operations, and carefully monitoring the operations for performance.

Drug Smuggling Investigations

Specific strategies in this area are: (1) to work with other border agencies to increase the smuggler's risk at and between ports of entry on the Southwest land border and in the commercial environment (cargo and containers); (2) to conduct aggressive investigative efforts (including undercover operations) to target air and marine smuggling organizations; and (3) to train cross-designated agents in policy, legal, and operational issues relating to drug smuggling investigations under the cross-designation program.

In 1992, Customs continued to achieve impressive enforcement results around the country. Over 23,000 total cases were handled. Customs investigative and interdictory activities pursuant to the Title 21 cross-designation agreement have resulted in over 6,000 arrests, 2,000 criminal indictments, 3,500 convictions, and 2,000 narcotics seizures. The current strategy and operational methodologies have resulted in record narcotics seizures.

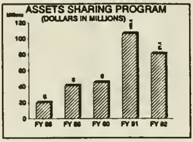




Financial Investigations

Customs seeks to disrupt the international illegal cash flow at its initial stage, destroying the financial infrastructure responsible for the movement of those funds, and effectively reducing the dollar amount available for global laundering and investment. Recent action directed toward this goal included expansion of Customs role in the development of money laundering control programs overseas through the Commissioner's International Money Laundering Initiative (CIMLI). This fosters a closer relationship with foreign counterparts, and increased participation in international forums which have significant impact on the development of money laundering control programs throughout the world.

The dollar value of money laundering seizures peaked in 1990 due to several factors: (1) a $135 million seizure of stolen United Kingdom Treasury Bonds which were subsequently returned to British authorities; (2) the extraordinarily high number of large seizures in 1990; (3) Customs decision in 1991 to de-emphasize "pick up" operations in order to focus on more quality arrests; and (4) successful law enforcement efforts regarding traditional banking institutions which caused a shift by criminals from cash to wire operations.



Customs Asset Sharing Program continues to flourish. From its inception in 1986 through 1992, Customs shared over $300 million resulting from currency and hard asset seizures with 424 local law enforcement agencies in 45 states, and since 1988, with eight foreign governments. The majority of these assets came from seized monetary instruments.

Fraud Investigations

Customs recently developed a national fraud enforcement strategy, which identifies, as one of its major objectives, the necessity and effectiveness of district fraud teams and a multi-disciplinary approach to fraud enforcement.

One area in which Customs has been operating in a multi-disciplinary mode is Jump Teams. These joint Enforcement/Commercial Operations teams were initiated in July 1990 to provide on-the-job experience and training in international business and trade operations, as well as in the workings of Customs foreign offices and their missions. The goal is to identify and prevent trans-shipments of textiles, confirm country production capacity, and facilitate and expedite the clearance of legitimate product.

Customs continues to focus investigative efforts toward cases with either significant or national impact. It has taken the lead in investigating violations relating to counterfeit and substandard aircraft parts. Also, Customs was instrumental in the formation of the Interagency Working Group on Product Substitution Fraud which dealt with the critical issue of substandard fasteners.

To do its job, Customs has increased the application of sophisticated investigative methods. For example, fraud investigations utilize the new Title III authority to intercept telephonic transmissions of facsimile machine data. Also, money laundering statutes have been utilized in a number of significant fraud cases. The first convictions ever obtained under Customs fraud-related RICO counts were obtained in New Orleans.

Customs continues to expand the use of money laundering statutes in the conduct of fraud investigations. Under these statutes, real estate and personal property, as well as cash "proceeds" of illegal activities, can be seized.

The investigation of hazardous and toxic waste imports and exports have been identified as a priority investigative area. Customs first criminal conviction in this area was in FY 1991 for violations relating to the importation of hazardous waste from Mexico.

Strategic Investigations

On August 2 and 9, 1990, President Bush issued Executive Orders prohibiting transactions with Iraq and Kuwait. Customs responsibility was to enforce the President's orders by blocking all unauthorized exports to those countries. In two months, Customs had effected more than 23 seizures of merchandise destined for Iraq and over 100 destined for Kuwait, for a total merchandise value of $8.2 million. Customs efforts were highly effective in supporting the war effort and enhancing national security. Customs is still aggressively following up on arms smuggling cases generated as a result of the Gulf War, with many high profile arrests and seizures.

Customs has had good success in its working relationships with foreign counterpart services and interagency groups as well as domestic agencies. It continues to expand such relationships to realize better coordination of export enforcement. Customs has also provided training in export enforcement to Eastern European customs services and other interested agencies.

Due to the great demand for the Office of Enforcement's highly successful Biological/Chemical Weapons Manual (a manual which provides detailed investigative guidance for cases involving the illegal export of biological/chemical weapons), a second printing was completed for wide distribution throughout U.S. and foreign enforcement agencies. Moreover, the Federal Law Enforcement Training Center is now creating a new special agent training program based on the manual.

Operation Exodus undercover operations are now being given a higher priority in view of their high success rate and their increased case acceptance by U.S. Attorneys. Also, improved relationships with the Office of Defense Trade Controls and the Defense Technology Security Agency have facilitated the procurement of export licenses for undercover operations.

At the beginning of FY 1992, Customs developed and issued a new policy which will facilitate the procurement of "flash" weapons and military equipment from the military services.

Aviation Program

Customs Aviation Program disrupts and disables the air transportation system used to deliver contraband, especially cocaine, to the U.S. In 1992, Customs increased the number of seizures and arrests, decreased the airborne drug smuggling threat, and established an unprecedented cooperative air interdiction program with the Government of Mexico.

Customs comprehensive strategy for the 1990's is based on the National Drug Control Strategy and built on past successes of the Aviation Program. Objectives and initiatives are designed to directly impact drug smuggling and transit in countries along our southern border.

The number of arrests and seizures have gone up during the last several years, but the majority now come from support activities (investigative and surveillance) rather than pure interdiction actions. The reason for this is that interdiction performance has dramatically altered air smuggling during the last several years; Customs has realized a significant increase in the probability of detecting air smuggling attempts, and a consequent decrease in the airborne drug smuggling threat to U.S. borders. Although smugglers now look for entry access other than through the air, the Aviation Program remains a powerful deterrent to the resurgence of air smuggling overflights.

Marine Program

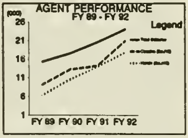
Customs also seeks to reduce the importation of drugs across our coastal borders through the diversion and disruption of maritime smuggling routes and patterns. To accomplish this, Customs implemented a revised strategy which included increasing fully integrated Air/Marine interdiction efforts; replacing unsuitable craft with seized, exchange sale, and purchased vessels; and reallocating resources taking into consideration the marine smuggling threat, a comprehensive cost effective approach, and the level of seizures and arrests.

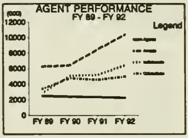
The Customs Enforcement Performance Program

During 1991, the Office of Enforcement developed a valuable tool which will enable it to better assess accomplishments and more effectively allocate resources. The "Customs Enforcement Performance Program" measures performance by using a number of indicators:

- o significant impact cases
- o arrests
- o indictments
- o convictions
- o seizures

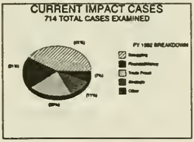
The results portrayed by these indicators are viewed in relation to investigative hours expended by agents in each office and are compared with Servicewide total results and investigative agent hours expended by all offices. Quality factors are also taken into account in the analysis of performance, including the investigative process and techniques, significant impact cases, and deterrence.





A recent review of significant impact cases revealed that, in general, these cases concern major drug traffickers, cartel families, money laundering by major traffickers and prominent citizens, nuclear or chemical weapons exports, or major commodities/major trading partner fraud. The significant cases were distributed across major investigative programs as follows: 40.8% drug smuggling; 20.6% financial/money;

20.3% trade fraud; 11.5% strategic (exports), and 6.8% other.



FINANCIAL HIGHLIGHTS AND ANALYSIS OF FINANCIAL PERFORMANCE

During 1992 Customs collected $20.16 billion as a custodian for other federal agencies and governments. Duties accounted for 91 percent and excise taxes 5 percent of these revenues, respectively. Of this revenue, 99 percent was returned to the Treasury, state, local, and other federal agencies and other governments.

Total operating expenses were approximately $1,736 million. Personnel compensation and benefits totalled approximately $1,060 million or 61 percent of the total operating expenses. Approximately $16 million of unfunded annual leave costs were included in the personnel compensation and benefits expense. Contractual service expenses were approximately $261 million or 15.0 percent of total operating expenses.

Custodial assets account for approximately $1,122 million or approximately 41 percent of the total assets of Customs. Custodial receivables of approximately $828 million primarily represent receivables relating to duties ($699 million or 84 percent). Overall, custodial assets represent those assets that will be distributed to Treasury, state, local and other federal agencies and other governments.

Operating assets account for approximately $1,593 million or 59 percent of the total assets of Customs. Operating assets consist primarily of fund balances with Treasury and cash (approximately $687 million or 25 percent of total assets) and property, plant and equipment (approximately $709 million or 28 percent of total assets).

Financial Highlights
(in thousands)

Custodial revenue collected	$20,156,684
Allocation of custodial revenue collected	$20,037,142
Total operating expenses	$ 1,736,325
Total personnel compensations and benefits expenses	$ 1,060,294
Personnel compensation as a percent of total operating expenses	61%
Total invested capital (inventories, property, plant and equipment)	$ 769,809
Total custodial future funding requirements	$ 34,444
Total operating future funding requirements	$ 108,695

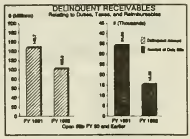
Analysis of Financial Performance

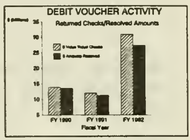
In FY 1992, Customs efforts in financial management related to the aggressive collection of accounts receivable, implementation of a new payroll system, reduction of interest payments, resolution of outstanding travel advances, improved reconciliation capabilities, and enhancement of controls over property and its related systems.

Improved Management of Delinquent Debt

Customs was able to reduce the delinquent debt (debt over 90 days) related to duties, excise taxes, reimbursable and miscellaneous receivables in FY 1992. Increased management emphasis was placed on the collection of delinquent debt in FY 1991. A Debt Collection Unit was formally established, an interim automated system developed to assist in the identification and collection of delinquent debt, and procedures were established to resolve debt with efforts focusing on direct contact with the debtor and surety collection efforts. The following chart highlights the progress Customs has made in decreasing the amount of delinquent debt (by $45.9 million) and the number of delinquent bills (by 18,815) from FY 1991 to FY 1992.

Customs has also enhanced its Debit Voucher System to improve accountability and collection of receivables resulting from checks returned from banking institutions because of non-sufficient funds, closed accounts, stop payments and a variety of other reasons. As a result Customs has been able to progressively increase its rate of collection in recent years.



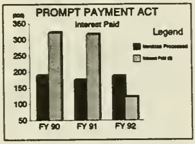


New Payroll System Implemented

During FY 1992 Customs employed an average of 20,021 individuals. In April, 1992, Customs converted to the Department of Agriculture Payroll System from the Department of the Treasury Payroll System. Major benefits of the new system include an automated billing system for collecting salary overpayments, an ability to input cost data, and a more accurate, paperless processing and approval of time cards. Customs has also expanded its usage of direct deposit transactions from 79 percent in FY 1991 to 84 percent in FY 1992.

Reducing Late Payment Interest

Customs met both the Treasury and Office of Management and Budget performance standards relating to the late payment of invoices in FY 1992. Treasury's established acceptable frequency rate for incurring prompt payment interest is two percent. The Office of Management and Budget has issued a standard that 98 percent of all payments to vendors be made timely. In FY 1992 Customs had a frequency rating of 1.95 percent and a processing rate of 98 percent. This compares with FY 1991 rates of 2.54 percent and 97 percent. This improvement occurred during a period when the number of invoices increased by 7 percent from 174,501 in FY 1991 to 186,756 in 1992.



Outstanding Travel Advances

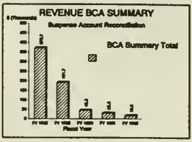
Customs implemented procedures defining the policy for collecting outstanding travel advances from employees using salary offsets. As a result of this policy and increased monitoring, outstanding advances decreased from $942 thousand in FY 1991 to $615 thousand in FY 1992. Customs also implemented a pilot program in the Northeast Region that allows employees to use their government Diners Club Card in automatic teller machines. This decreases the use of Federal monies to fund travel advances. Program implementation is expected Customswide by 1994.

Major Improvements in Collection Deposit Reconciliation

In FY 1989 Customs had within its own systems substantial unreconciled differences between collections and deposits, and unreconciled differences with the Treasury. After systems enhancements and reconciliation efforts were completed, Customs was able to identify and correct the internal imbalances. Customs has since implemented a new Cashlink system that provides an interface between Customs and the Treasury, Financial Management Service mainframe computers. This interface compares Customs collection records to the deposits reported to the Treasury by financial institutions, and produces a daily listing of deposit exceptions. Prior to Cashlink, Customs was not able to begin the reconciliation process for 6 - 8 weeks because of the lack of deposit documentation. The deposit exception reconciliation between Treasury and Customs is now accomplished in days instead of months.

Improved Performance in Suspense Fund Reconciliations

Customs has been able to reduce the amount in its Revenue Budget Clearing Account (BCA) in recent years in a decreasing period of time due to increased reconciliation efforts and the implementation of the Cashlink system. The Revenue BCA is a suspense fund where Customs deposits amounts collected when the amount can not be readily identified with a specific collection entry. The Office of Management and Budget has identified performance criteria for reconciling suspense accounts at clearing 90% of the transactions within 90 days of their initial posting. While



Customs has not yet met this measure, the chart above highlights the progress that has been made.

As the chart shows, reconciliations efforts have concentrated on the recent years. Differences from fiscal years 1988 and 1989 are being resolved on a time available basis.

Disbursement Reconciliations

Customs was successful in routinely meeting a number of critical reconciliation measures identified by the Office of Management and Budget in FY 1992. These reconciliations include:

- Statement of Differences Disbursing Office Transactions (monthly).
- Statement of Differences Deposit Transactions (monthly).
- Undisbursed Trial Balance to Customs General Ledger (monthly).
- Report of Unavailable Receipt Transactions to Customs General Ledger (monthly).
- Report on Budget Execution to the Report on Obligations (quarterly).
- Report on Budget Execution to the Year end Closing Statement (annually).

Similar to the Revenue BCA suspense account, Customs also has a suspense account containing undistributed differences resulting from disbursements originating in the Federal automated disbursing system not being processed within three months. OMB requires clearing 90 percent of the transactions within 90 days for this account. Customs currently has a backlog in this account due to staffing, procedural deficiencies, and the training required at year end for the implementation of a new accounting system. Customs has implemented steps to reduce the backlog by focusing the existing staff on current processing, providing additional temporary staff to resolve the backlog, and initiating a study to resolve the procedural deficiencies.

Reconciled Property and Accounting Systems

In FY 1992 Customs reconciled the $606 million of equipment contained in its property management systems to the general ledger. In prior years Customs had significant imbalances between the property and accounting systems. To resolve the imbalances, Customs implemented an aggressive reconciliation of FY 1990, 1991, and 1992 property records. Monthly reconciliation procedures were developed and implemented. The capitalization threshold for property was modified to comply with existing General Accounting Office standards. Numerous policy directives and procedure manuals were developed to provide greatly improved accountability, manageability and inventory standards. A quality assurance risk model was developed to identify high risk areas requiring review and assistance. The annual physical inventory procedures were streamlined resulting in a successful reconciliation of perpetual and physical property records during the FY 1992 annual inventory. Lastly, a Central Data Entry Unit was established that creates temporary property records for accountable property when ordered, and processes all disposal records. These efforts have resulted in accurate property records containing proper dollar valuations and a general ledger that agrees with the detail records of the property systems.

Financial Statements

The financial statements presented as part of this total package present the financial position, results of operations and cash flows of the U. S. Customs Service for the year ended September 30, 1992, pursuant to the requirements of the Chief Financial Officer's Act of 1990. It should be noted that the financial statements differ from the financial reports used to monitor and control budgetary resources. Also, the financial statements should be reviewed with the realization that they are for a sovereign entity, that unfunded liabilities reported in the financial statements cannot be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

FINANCIAL MANAGEMENT SYSTEMS INITIATIVES

Current Status of Financial Management Systems

Customs has begun a broad based project to improve the quality and effectiveness of financial management, accounting, and budgeting systems, practices, and procedures. The project is known as AIMS, the Asset Information Management System and encompasses an integrated financial management system. It will provide Customs with a financial system that will resolve Federal Managers' Financial Integrity Act (FMFIA) deficiencies and meet Joint Financial Management Improvement Program (JFMIP) Core Requirements. It will also modernize and streamline Customs administrative systems and procedures.

The objective of the AIMS project is two-fold:

(1) To implement a modern financial system which corrects current deficiencies and is compliant with federal financial systems requirements, and

(2) To integrate and upgrade ancillary administrative systems.

The first goal was met in Phase I of the AIMS project. A new core financial system was implemented on October 1, 1992. The second goal will be met in Phase II of the project which is now underway in FY 1993. Highlights of AIMS and other Customs major systems projects this fiscal year are presented in the following paragraphs.

Implementation of the new core financial system. After analyzing the options, Customs determined that off-the-shelf software could best meet Customs need for a financial system. The Federal Financial System (FFS), developed by American Management Systems, was selected.

- This supports Customs, and the Government's, goal of using off-the-shelf software to the extent possible.
- FFS is fully compliant with JFMIP Core Financial System Requirements and GAO accounting requirements.
- FFS provides system generated external reports to meet Treasury and OMB requirements.
- FFS modernizes Customs processing by providing on-line edit and update.
- Customs worked with the vendor to configure FFS and develop interfaces to ancillary systems.

Improved reports capabilities. As part of the AIMS project, Customs recognized the need to place additional focus on reports from the new system.

- Customs is developing an easy to use, automated reports system.
- This will provide users with reliable and timely information from the system.
- Customs implemented essential reports on October 1, 1992.
- Full automated and advanced capabilities are now being developed.

Cost accounting. In conjunction with the AIMS project, Customs will be working toward a cost accounting system, which it currently does not have.

- This will resolve a current, and long standing, FMFIA deficiency.
- As part of the new Department of Agriculture payroll system, a labor distribution system was custom developed and implemented in April 1992.
- Off-the-shelf software (the FFS Project Cost Accounting System) will be used for project cost accounting. It provides project budgeting and costing, plus tracks reimbursable agreements, receivables, and obligations at the detail level.
- Customs requirements for cost accumulation and distribution are now being defined.
- The cost accumulation and distribution requirements will be completed this fiscal year and a determination made as to how to meet the requirements.

New payroll system. As part of a Treasury-wide initiative, Customs converted to the Department of Agriculture payroll system in April 1992.

- This supports the government's goal of consolidating systems using cross servicing.
- Customs developed an automated system where timekeepers enter data which is edited and then later interfaced to Agriculture.
- Requests for security access to the new system were automated by enhancing the existing AIMS Security Module, beginning the process of standardizing and integrating access requests for administrative systems into one system.

Annual financial statements. Customs is one of the pilot agencies undergoing financial statement audits for FY 1992.

- Requirements identified by Customs audit team and outside auditors were addressed to the extent possible when the new core system was implemented October 1, 1992.
- Customs intends to meet all requirements in the second phase of the AIMS project.
- When final report requirements are published by OMB, they will be integrated into FFS by the vendor, and Customs will implement the upgrade when it is available.

Revenue systems improvement. Customs will improve the automated revenue programs and systems by redesigning and enhancing the financial aspects of the Automated Commercial System (ACS).

- This will bring revenue systems into compliance with GAO, CFO and JFMIP requirements.
- This will provide better control over Customs collections.
- This will provide for better measures of performance in the collections and receivables areas.
- The project was initiated in the last quarter of FY 1992 and is in its initial stages.

Plans for Financial Management Systems Improvements

Customs financial systems plans are in two major areas. These are: (1) financial systems and (2) revenue systems.

Financial Systems. Customs prior core financial system, the Customs Accounting and Management Information System (CAMIS) was purchased off-the-shelf, customized and installed in 1980. In recent years, it became apparent that the system had several shortcomings, including not meeting the JFMIP requirements and Customs increasing requirements. In addition, through FMFIA reviews and GAO audits, Customs financial systems were found to have significant deficiencies.

Customs determined that CAMIS should be replaced due to the problems mentioned above and the fact it was nearing the end of its system life cycle. As a result of this decision, the Asset Information Management System (AIMS) project was begun. The goals of AIMS were described above.

The first goal of the AIMS project was met in Phase I of the AIMS project. A new core financial system was implemented on October 1, 1992. Customs used off-the-shelf software for the core system and made only essential changes to the vendor package. The system operates in Customs current computer operational environment, in addition to being upgradeable to the DB2 relational database technology should Customs decide to do so. Customs existing ancillary systems were interfaced into the core system, and only essential changes to the systems were made.

The second goal will be met in Phase II of the AIMS project. Customs plans to integrate the ancillary systems into the core system to update the core on-line, reduce redundant files, and minimize reconciliation efforts. In addition, Customs plans to expand and enhance all ancillary systems to add increased functionality, streamline systems and procedures, move towards a more paperless environment, and provide timely and reliable information useful in effective resource management.

In both phases of the AIMS project, Customs intends to use off-the-shelf software where appropriate. Customs also intends to work with other Treasury agencies to share system related work efforts. The possibility of taking the lead in developing Treasury-wide systems will be evaluated.

Revenue Systems. The Automated Commercial System (ACS) was developed with operational needs as the major concern and at a time when Customs financial programs were regionalized. Most of the financial related aspects of ACS are among the older parts of the system. ACS does not fully support the JFMIP requirements or the audit requirements of the CFO legislation. A recent GAO report of financial management in Customs points out that the financial systems do not adequately account for and control resources.

Customs determined there is a need to improve the automated revenue programs and systems due to the problems mentioned above. Customs intends to redesign and enhance the financial aspects of ACS through a long term effort.

The goals of the revenue systems improvement project are:

(1) provide better control over Customs collections,
(2) bring revenue systems into compliance with GAO, CFO and JFMIP requirements, and
(3) take advantage of state of the art technology to maximize systems efficiency.

The project will be a joint effort between the Office of Information Management's Office of Automated Commercial Systems and the Office of Management's AIMS Division.

Software will be developed following standard life cycle development procedures. This includes: analysis, user requirements, functional requirements, system design, programming, system testing, documentation and training.

The project was initiated in the last quarter of FY 1992 and is in its initial stages. It will be a key element in an overall redesign planned for the Automated Commercial System.

FMFIA PROGRAM SUMMARY

Description of Customs FMFIA Program

Under the Federal Managers' Financial Integrity Act, a government-wide system for reviewing management controls and conformance with Comptroller General standards was implemented through OMB Circulars A-123 and A-127. More recently, the CFO Act re-emphasized the requirement, originally stated in A-127, that Federal agencies develop and maintain integrated agency accounting and financial management systems, including financial reporting and internal controls.

Customs is continually working to improve the agency's Management Controls Program. Regular evaluations of controls at both Headquarters and regional levels are being conducted in accordance with OMB guidelines. Coordination of both Section 2 (program controls) and Section 4 (accounting systems) of the FMFIA is vested in the new Management Controls Division, which is part of the Office of the Comptroller and the Office of Management.

Summary of FMFIA Accomplishments

o Customs Management Controls Division was established in 1990 to oversee an effective management control system.

o Customs has been aggressively identifying and pursuing completion of material weaknesses and actions to improve controls in Customs. It was reported in FY 1989 that Customs financial management system was not in conformance with the Comptroller General's standards. As a consequence, there has been a focus on correcting Customs problems with data integrity (accounting and cost information), and funds control and collection of accounts receivable.

o Initiatives are underway to enhance extensive parts of the Automated Commercial System and to further develop the Asset Information Management System. The resulting improved systems will improve controls over accounting, cost information, and reconciliation activities.

o Risk assessments and event cycle documentation for program areas were updated in FY 1990 and will be updated again in FY 1993.

o Customs has initiated several efforts to standardize and improve regional management control review programs including an automated reporting and review system for compliance reviews. In addition, work is progressing to standardize critical checklists used by the regions to do these reviews.

o A major effort was begun to produce management control "red flag" reports from existing records in Customs Automated Commercial Systems and to produce early warning reports from financial and administrative systems. Some reports are in production and others are under development.

- The status of actions and reviews scheduled in Management Control Plans and corrective actions for material deficiencies are now tracked on a monthly basis and reported through Treasury's Inventory, Tracking, and Closure System.

- Aggressive followup has been instituted to ensure effectiveness of corrective actions. A validation process for correction of material deficiencies has been developed that identifies validation criteria, validation methodologies, and coordinates validation efforts of Customs offices.

- Management control training has been revised and training efforts intensified. A management controls video is also nearing completion.

- Customs has developed an official "Early Warning" system of reporting significant happenings to the Department through its Intelligence Operations Center.

- Customs has begun a regular recurring program of reviews of regional FMFIA programs.

- Customs has established an effective automated funds control system to prevent the possibility of spending violations and significantly improve internal controls over financial management.

- Customs has implemented formal end-of-year operating procedures, and daily monitoring of the status of resources at the end of the year.

- Customs has implemented the new on-line reconciliation procedures called CASHLINK which allows rapid reconciliation of all deposit issues.

- Customs has enhanced its financial management organization in preparation for fully implementing the Chief Financial Officers Act by reorganizing its financial management organization, filling vacancies with highly qualified management and staff, developing plans to monitor improvements in financial areas on a monthly basis, establishing a permanent staff to implement a new core accounting system that will interface with other financial related systems, and providing staff and financial assistance to meet the requirements of the CFO Act.

- Customs has acted to familiarize its managers with techniques for developing, selecting, and utilizing performance indicators in evaluating their programs, as required under the CFO Act.

Unresolved Deficiencies

High Risk Areas

Data Integrity: This area involves problems that have occurred due to the lack of effective General Ledger control, inability to reconcile accounts on a timely basis, and system inefficiencies.

Improvements in Customs financial systems including our funds control module, the introduction of a new electronic mechanism called CASH LINK for reconciliation of deposits, and the formal implementation of our new core financial system have effectively addressed General Ledger and reconciliation concerns. Corrective actions to improve controls over the Treasury Enforcement Communications System (TECS) II records have resolved another data integrity issue. A final corrective action involves development of a better cost attribution methodology for use by Customs managers. The new cost approach is scheduled to be ready by October 1993.

Collection of Receivables: There has been a need to improve collection/accounting systems for revenues on imports and to develop better financial systems for accounting and follow-up to collect receivables.

Corrective actions have been taken for all the specific deficiencies originally listed as part of this high risk area. This includes action to improve timeliness of deposits, expedite processing of protests, resolve debit vouchers received for bad checks, improve recording and follow-up action on mail entries, resolve delinquencies related to promissory notes, deal with undeposited collections reported on the Statement of Accountability (CASH LINK) and reconcile the Statement of Accountability, and significantly improve controls over serially numbered forms used in the collection process. Going beyond our original corrective action plan in this area, Customs has recently requested FY 1994 funds for the Customs Automated Revenue Accounting (CARA) redesign project, which would provide significant improvement in internal controls affecting revenue collection in ACS. Although this is an area which should continue to bear continuous scrutiny, it is also an area in which corrective action has significantly reduced our risks.

Controls over Obligated and Unobligated Balances for Customs Operations and Maintenance (O&M) Account: Customs has experienced problems in determining actual O&M account balances due to inadequacies in tracking obligations and expenditures associated with interagency agreements and related contracts.

Corrective actions to address these problems are underway. In the summer of 1992, Customs hired the accounting firm of KPMG Marwick to review the account balances of the air/marine program, and they have completed their review and issued a draft report with recommendations. Recommendations of Treasury's own study team will be coordinated with the Peat Marwick recommendations and corrective action will be implemented to improve the account's internal controls. The Inspector General will review results of both efforts.

Other Material Weaknesses

In FY 1992 Customs was able to eliminate problems with controls over collection documents, and was able to close several other deficiencies. Accounting and follow-up on duties and taxes for mail entries was improved through new mail entry and collection systems in ACS. New policies and procedures were finalized for better auditing and controls over Undercover Operations. Customs also formalized procedures for year-end accounting adjustments which will permit accrual accounting in accordance with GAO standards.

In addition to the material weaknesses which we have been addressing in our two high risk areas, Customs carried over into FY 1993 plans to correct weaknesses related to its inability to properly age accounts receivable for reporting purposes, to ensure correct and timely liquidation of entries, to better manage the allocation of expenditures for inspectors' overtime, and to reconcile property values recorded in both our property management and primary accounting systems. Corrective actions for the last two of these were subsequently completed.

There were four new material weaknesses or non-conformances listed in Customs 1992 FMFIA Annual Report. The most important reflects GAO concerns over the adequacy of Customs framework to assure that trade enforcement efforts are effective and efficient. Corrective action will involve implementation of Customs new Trade Enforcement Strategy. A second involves the need for improved compliance with existing controls over seized property, primarily narcotics, and adequate storage facilities for these items. The third (discussed as a high risk area above) relates to a need for improved tracking of obligations and expenditures associated with interagency agreements, permitting easier determination of correct balances for the Operations and Maintenance Account; and the fourth to the need for more timely adjustments of accounts receivable to reflect deferred tax payments and for timely billing of Harbor Maintenance Fees.

Blue Ribbon Panel Update

In FY 1992 Customs proceeded with implementation of an action plan to resolve concerns about agency management and integrity issues identified by the Blue Ribbon Panel which was appointed in June 1991. This effort has gone well. During this period, Customs launched a well coordinated effort to implement the Panel's recommendations. Each of the 51 recommendations in the Panel's report was studied thoroughly and acted upon in some way. Customs developed 13 action plans, with over 100 milestones, to ensure that the spirit and intent of the recommendations were properly carried out. This effort has resulted in significant and far-reaching reforms throughout the Customs Service. Customs is providing the Department with formal, semi-annual reports of progress on Blue Ribbon Panel implementation, as well as informal, ad hoc updates. Customs sees itself in a strong position to assure that the recommendations are fully implemented and that the problems found in one part of Customs will not recur elsewhere.

Consolidated Statement of Financial Position

Department of the Treasury, United States Customs Service

Consolidated Statement of Financial Position

As of September 30, 1992

(Dollars in Thousands)

Custodial assets:	
Undistributed funds with Treasury (Note 6)	$ 213,706
Receivables, net of uncollectible amounts of $76,943 (Note 2)	827,895
Forfeited property and currency (Note 3)	74,257
Other (Note 4)	6,050
Seized property and currency (Note 5)	-
Total custodial assets to be distributed	1,121,908
Fund balance with Treasury - refunds and drawbacks (Note 6)	9
Total custodial assets	1,121,917
Operating assets:	
Financial resources:	
Fund balances with Treasury and cash (Note 6)	687,005
Receivables from reimbursable services and user fees, net of uncollectible amounts of $7,789 (Note 7)	44,493
Intragovernmental receivables	71,910
Non-financial resources:	
Advances and prepayments	19,828
Aircraft parts and materials	60,191
Property, plant and equipment (Note 8):	
Aircraft	349,322
Other	360,296
Total operating assets	1,593,045
Total assets	$2,714,962

The accompanying notes to the consolidated financial statements are an integral part of this statement.

Custodial liabilities:	
Custodial assets to be distributed	$1,121,908
Accrued refunds and drawbacks (Note 9)	34,443
Capital lease obligation	1
Total custodial liabilities	1,156,352
Custodial net position (Note 10):	
No-year appropriations	9
Future funding requirements	(34,444)
Total custodial net position	(34,435)
Total custodial liabilities and net position	1,121,917
Operating liabilities:	
Funded operating liabilities:	
Accounts payable	73,413
Accrued payroll and benefits (Note 11)	81,442
Intragovernmental liabilities	8,079
Other	11,700
Total funded operating liabilities	174,634
Unfunded operating liabilities:	
Accrued annual leave	67,839
Capital lease obligations (Note 12)	16,993
Accrued unemployment and workmen's compensation	23,863
Total unfunded operating liabilities	108,695
Total operating liabilities	283,329
Commitments and Contingencies (Note 13)	
Operating net position (Note 14):	
Authorized retained capital	238
Appropriated funds with Treasury:	
Unliquidated obligations	361,444
No-year and other appropriations	68,735
Reserve for advances and prepayments	7,726
Invested capital:	
Aircraft parts and materials	60,191
Property, plant and equipment	709,618
Cumulative results of operations	210,459
Future funding requirements	(108,695)
Total operating net position	1,309,716
Total operating liabilities and net position	1,593,045
Total liabilities and net position	$2,714,962

The accompanying notes to the consolidated financial statements are an integral part of this statement.

Consolidated Statement of Operations and Changes in Operating Net Position

Department of the Treasury, United States Customs Service

Consolidated Statement of Operations and Changes in Operating Net Position

for the year ended September 30, 1992

(Dollars in Thousands)

Custodial activities:	
Revenues collected:	
Duties	$18,311,802
Excise taxes	1,081,670
User fees	533,308
Forfeited pcoperty and currency	166,033
Fines and penalties	42,608
Interest and others	21,263
Total revenues collected	20,156,684
Allocations of revenues collected:	
Department of the Treasury	19,898,819
Department of Agriculture	40,891
State, local, other Federal agencies and other Governments	97,432
Total allocations of revenues collected	20,037,142
Net revenues collected	119,542
No-year appropriations expended for refunds and drawbacks	775,325
Refunds and drawbacks expense	775,325
	-
Net revenues collected and available to offset funded operating expenses	119,542
Operating activities:	
Financing sources:	
Appropriations expended for operations	1,335,156
Reimbursable services and user fees retained	307,072
Total financing sources	1,642,228
Operating expenses:	
Personnel compensation and benefits	1,060,294
Travel and transportation	50,677
Rent, communications and utilities	155,942
Printing and reproduction	5,250
Purchases of evidence and information	49,659
Contractual services	260,502
Repairs and maintenance	108,258
Interest and other	45,743
Total operating expenses	1,736,325
Less unfunded operating expenses	15,793
Total funded operating expenses	1,720,532
Excess of financing sources over funded operating expenses	41,238
Operating net position, as of October 1, 1991	1,237,912
Other changes in operating net position (Note 14)	30,566
Operating net position, as of September 30, 1992	$ 1,309,716

The accompanying notes to the consolidated financial statements are an integral part of this statement.

Consolidated Statement of Cash Flows

Department of the Treasury, United States Customs Service

Consolidated Statement of Cash Flows

for the year ended September 30, 1992

(Dollars in Thousands)

	Custodial	Agency
Cash flows from operating activities:		
Excess of financing sources over funded operating expenses	$ -	$ 41,238
Adjustments affecting cash flows from operating activities:		
Appropriations expensed	(775,325)	(1,355,564)
Decrease (increase) from custodial and operating receivables	(135,031)	28,331
Decrease (increase) in inventory of forfeited assets	17,295	-
Increase in inventories not held for sale	-	20,408
Decrease (increase) in advances and prepayments	(1,052)	13,972
Decrease in custodial assets to be distributed and funded liabilities	(2,090)	39,019
Other, net	-	11,912
Net cash used by operating activities	(896,203)	(1,200,684)
Cash flows from investing activities:		
Purchases of invested capital	-	(204,772)
Net cash used by investing activities	-	(204,772)
Cash flows from financing activities:		
Appropriations (current warrants)	742,298	1,456,409
Return of "M" Year funds to Treasury	-	(5,334)
Payments on capital lease obligations	-	(10,754)
Net cash provided by financing activities	742,298	1,440,321
Net increase (decrease) in cash and cash equivalents	(153,905)	34,865
Cash and cash equivalents, beginning of period	367,620	652,140
Cash and cash equivalents, end of period	$213,715	$ 687,005

The accompanying notes to the consolidated financial statements are an integral part of this statement.

Consolidated Statement of Reconciliation to Budget

Department of the Treasury, United States Customs Service

Consolidated Statement of Reconciliation to Budget

for the year ended September 30, 1992

(Dollars in Thousands)

Total funded operating expenses	$1,720,532
Add:	
Allocation of revenues collected	178,361
Property, plant and equipment acquisition	178,574
Distribution to Treasury	49,198
Inventory purchases	26,198
Cash disbursements for mortgages, claims and refunds	2,755
Net reversals of prior year payables and additional current year payables	56,409
Less:	
Inventory used in operations	(20,408)
Distributions not requiring outlay:	
Property transferred to other Federal agencies and to state and local governments	(10,209)
Net adjustment to reimbursement revenue	(178,434)
Non-appropriation expenditures	(7,325)
Expended appropriations	1,995,651
Less reimbursements	(111,642)
Expended appropriations	$1,884,009

The accompanying notes to the consolidated financial statements are an integral part of this statement.

Notes to Consolidated Financial Statements

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies:

Basis of Presentation

The Chief Financial Officers Act of 1990 (CFO Act) requires executive agencies of the Federal government to prepare and have audited financial statements and related footnotes for all agency activities and funds. The financial statements are prepared in conformity with applicable generally accepted accounting standards and principles for Federal entities, as well as Office of Management and Budget (OMB) Bulletin No. 93-02 which defines the form and content of financial statements of executive departments and agencies. These standards, principles and other guidance used to prepare such financial statements are a comprehensive basis of accounting other than generally accepted accounting principles.

The accompanying consolidated financial statements include the accounts of all funds under Customs' control or which Customs' activities impact, consisting of thirty-nine (39) custodial funds and eight (8) operating funds. All inter-fund balances and transactions have been eliminated. Certain modifications and variations to the principles and guidelines, described above, have been made to the accompanying financial statements in order to more clearly present the financial position and results of operations of Customs.

Reporting Entity:

The United States Customs Service (Customs), with headquarters in Washington, D.C., was created in 1789 and is now a part of the Department of the Treasury (Treasury). Customs is primarily responsible for administering the U.S. Trade Program and the U.S. Narcotics Enforcement Program. Customs' primary responsibilities include: (1) enforcing the laws governing the flow of merchandise or commerce across the borders of the United States; (2) assessing and collecting duties, excise taxes, fees and penalties due on imported and other goods and services; and (3) enforcing drug-related and other laws and regulations of the United States on behalf of Federal agencies and/or in conjunction with various state, local and other Federal agencies and foreign countries.

Currently, Customs is operating second only to the Internal Revenue Service in the collection of revenues for the Federal government. Similar to other Federal agencies, funding for Customs' operations is provided principally through annual congressional appropriations.

Consolidated Financial Statements Presented

Substantially all of the revenues collected by Customs are remitted to the Treasury, U.S. Department of Agriculture, state and local agencies, other Federal agencies and other Governments (i.e., Puerto Rico, Virgin Islands) in accordance with the various laws and regulations governing the operations and activities of

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Consolidated Financial Statements Presented (continued)

Customs. These activities reflect the custodial/fiduciary responsibilities that Customs, as an agency of the Federal government, has been authorized by law to enforce.

The financing sources to cover the operating and other costs incurred from the activities described above are provided principally through congressional appropriations on an annual, multi-year, and a no-year basis. Accordingly, operating costs incurred and, therefore, recorded as expenses are offset by an equal amount of appropriated funds that are recorded as financing sources.

The form and content of the Consolidated Statement of Financial Position, as suggested by OMB Bulletin No. 93-02, has been adjusted to present custodial assets to be distributed (and an offsetting liability) for revenues collected or to be collected but not yet distributed to the various entities expected to receive these funds. Principally all of these revenues are not considered as financing sources (revenues) available for the operations of Customs.

To more accurately present the results of its principal activities (i.e. custodial/fiduciary responsibilities) and the funding of such, Customs has presented for 1992, a "Consolidated Statement of Operations and Changes in Operating Net Position". The form and content of the statement, as suggested by OMB Bulletin No. 93-02, has been modified to present custodial activities separately from the operating activities of Customs. The custodial activities represent the fiducial responsibilities of Customs in contrast to the operating activities where the financing sources are provided principally through congressional appropriations.

Revenue and Expense Recognition

Revenue generated from Customs' custodial activities is recognized when the cash is collected. The significant types of revenues collected, related expenses and a description of these include:

- Duties: amounts collected on imported goods;
- User fees: fees associated with services performed by Customs agents or other officials within port authority, for the harbor maintenance and other miscellaneous fee programs;
- Excise taxes: taxes collected for the Internal Revenue Service on imported distilled spirits and liquor;
- Fines and penalties: amounts collected for violations of law and regulations;

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Revenue and Expense Recognition (continued)

- Forfeited currency and property: revenue collected from forfeited currency, sales and distributions of forfeited property, and payments in lieu of forfeiture as a result of Customs' criminal and other investigations; and,

- Refunds and drawbacks: refunds include overpayments, duplicate payments, etc., to importers, while drawbacks are payments to importers and other claimants for a portion of the initial duties and taxes collected on imported goods where the goods are subsequently exported to foreign markets.

Financing sources from appropriations expensed are recorded as revenue when the related cost is incurred and recorded as an expense. Revenues from reimbursable services and user fees to be retained (19 U.S.C. 58c.) are recorded as earned when the service is completed and are net of amounts deemed uncollectible.

Expenditures for operating costs are recorded as expenses when goods are received, inventory used, or the services are incurred.

Custodial Assets and Liabilities

Custodial assets consist principally of undistributed funds with Treasury, receivables, and forfeited property which are to be distributed primarily to the Treasury, other Federal agencies, state and local agencies and other governments. Because substantially all of the custodial assets are not considered financing sources (revenues) available to offset operating expenses of Customs, a corresponding liability is recorded and presented as "Custodial Assets to be Distributed" in the Consolidated Statement of Financial Position to reflect the custodial nature of Customs' activities.

Customs receives annual increases to its no-year appropriation balance with Treasury to fund refunds and drawbacks of duties and taxes paid during the fiscal year. Accrued refunds and drawbacks in excess of these appropriated funds are unfunded and are included as "future funding requirements" within Custodial Net Position.

The presentation of custodial assets, liabilities and net position in a separate, self-balancing set of accounts ensures that financial and non-financial resources of Customs present only those resources which will be consumed in current or future operating cycles while the custodial categories contain resources relating to Customs' custodial/fiduciary activities.

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Undistributed Funds with Treasury

Undistributed funds with Treasury represents custodial monies, excluding forfeited currency, to be distributed to various Federal, state or local agencies. The monies held represent the timing differences between when the monies are received and when the distribution of the funds occurs.

Receivables

Receivables included as a component of custodial assets consist of duties, user fees, excise taxes, fines and penalties and interest which have been billed or accrued and remain uncollected as of September 30, 1992. These receivables are net of amounts deemed uncollectible which is judgmentally determined and considers past collection experience, write-off history, analyses of the types of receivables outstanding, and a detailed review of aged balances.

Forfeited Property and Currency

Forfeited property and currency are generated from the forfeiture of currency and other monetary instruments and real and personal property seized by Customs under authority granted to it by the Tariff and Trade Act of 1984 and the Anti-Drug Abuse Act of 1988. Forfeited property is recorded at estimated net realizable value based on historical sales experiences.

Proceeds from these activities, net of authorized administrative and enforcement expenses allowed by the Tariff and Trade Act and the Anti-Drug Abuse Act, amounts allocated to state, local and other federal agencies, the sum of $15 million, unliquidated obligations and reserve for advances and prepayments at the end of each fiscal year, are recorded as custodial assets to be distributed for payment to the general fund of the Treasury. As of September 30, 1992, the remaining $238 thousand balance that, by law, is not remitted, is considered as "Authorized Retained Capital", the net of which is presented as a separate component of operating net position in the Consolidated Statement of Financial Position.

Seized Property and Currency

Seized property and currency result principally from enforcement activities. These items are not considered a custodial asset until judicially or administratively forfeited and, accordingly, are not reflected as custodial assets in the Consolidated Statement of Financial Position.

Fund Balances with Treasury and Cash

Fund balances with Treasury are the amounts remaining as of fiscal year end within funds Customs receives an appropriation, and imprest fund balances. The fund balances with Treasury represents the amounts remaining but not yet spent.

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

<u>Cash Equivalents</u>

For the purpose of the Consolidated Statement of Cash Flows, cash includes: custodial undistributed funds with Treasury, a custodial fund balance with Treasury and operating fund balances with Treasury and cash.

<u>Receivables from Reimbursable Services and User Fees</u>

Receivables from reimbursable services and user fees represent amounts due from various parties for services performed which Customs, by law, has the right to bill for reimbursement of costs incurred.

<u>Intragovernmental Receivables and Liabilities</u>

Intragovernmental receivables and liabilities represent amounts due from or due to various other Federal agencies under contractual agreements or other arrangements for services or other activities performed for or by Customs. Customs has recorded a receivable from other Federal agencies totaling $71.9 million for goods and services which had been provided through September 30, 1992. Customs has also recorded a payable to other Federal agencies totaling $7.2 million for goods and services received.

<u>Advances and Prepayments</u>

Payments in advance of the receipt of services are recorded as prepaid charges and recognized as expenses when the related services are received. A reserve for advances and prepayments, a separate component of Customs' consolidated operating net position, is increased (credited) for the amount of appropriated funds spent, but not yet obligated, for these deferred charges. The deferred charges consist principally of advances to agents for use in conducting investigative operations. Upon incurrence of the related expenses and, therefore, the recording of an operating expense, the related reserve for advances and repayments amount is decreased and appropriations expended for operations, a financing source, is increased.

<u>Aircraft Parts and Materials</u>

Aircraft parts and materials are stated at replacement cost. As of September 30, 1992, aircraft parts and materials consist principally of material and supplies held for future consumption, with a replacement value of approximately $60.2 million. Invested capital, a separate component of Customs' operating net position, is increased (credited) for an amount equivalent to the cost of the inventory with a corresponding decrease (debit) to Customs' appropriated funds. A valuation allowance is established, principally as a result of obsolescence, to reduce the carrying value of inventories to market with a corresponding direct charge to the related separate component of Customs' operating net position. When

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Aircraft Parts and Materials (continued)

ultimately used in Customs' operations, an operating expense (reducing inventories) and a financing source (reducing invested capital) equal to the original cost of this inventory are recorded. Any related valuation allowance previously established is reversed with an offsetting credit to the related separate component of Customs' operating net position.

Property, Plant and Equipment

Purchased property, plant and equipment, transferred property from other Federal agencies, and forfeited property with a value of $5,000 or greater is capitalized and recorded as an asset. The invested capital account is increased (credited) for an amount equivalent to the capitalized cost of the asset with a corresponding decrease (debit) to Customs' appropriated funds.

Expenditures for normal repairs and maintenance are charged to expense as incurred. Expenditures greater than $5,000 for improving or rebuilding an existing asset that extends its useful life are capitalized.

Depreciation expense and amortization is not recorded because it does not provide meaningful information to the management of Customs and most other Federal agencies in determining capital expenditure needs.

Upon legal transfer of property, plant or equipment receiving approval for disposal, the asset is removed from the statement of financial position.

Funded and Unfunded Operating Liabilities

Funded operating liabilities are those liabilities incurred for which Congress has appropriated funds during the current or prior fiscal year. Unfunded operating liabilities are liabilities resulting from goods or services received in the current or prior periods in excess of available Congressional appropriated amounts. The liquidation of the unfunded liabilities are dependent on future Congressional appropriations. The expenses associated with these unfunded operating liabilities are recorded as operating expenses in the Consolidated Statement of Operations and Changes in Operating Net Position. The unfunded expenses are deducted from total operating expenses to arrive at total funded operating expenses.

Total unfunded operating liabilities in the Consolidated Statement of Financial Position agrees to the total of Future Funding Requirements presented as a separate component and as a reduction of Customs' operating net position.

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Accrued Annual Sick and Other Leave

Annual leave is accrued as an expense when earned. To the extent current or prior year appropriations are not available to fund annual leave earned but not taken, funding will be obtained from future funding sources. The accrual is presented as a component of unfunded operating liabilities in the Consolidated Statement of Financial Position. The accrual is adjusted during the year for changes in compensation rates and reduced for the annual leave taken. Sick and other types of leave are expensed as taken and are not accrued when earned.

Retirement Plans

The majority of Customs' employees participate in the Civil Service Retirement System (CSRS), to which Customs makes matching contributions equal to seven percent (7%) of pay, or seven and a half percent (7.5%) for those personnel classified as law enforcement agents. Customs does not report CSRS assets, accumulated plan benefits, or unfunded liabilities, if any, applicable to retirement plans as the accounting for and reporting of such amounts is the responsibility of the Office of Personnel Management.

On January 1, 1987, the Federal Employees Retirement System (FERS) went into effect pursuant to Public Law 99-335. Most employees hired after December 31, 1983, are automatically covered by FERS and Social Security. Employees hired prior to January 1, 1984, can elect to either join FERS and Social Security or remain in CSRS. A primary feature of FERS is that it offers a savings plan to which Customs automatically contributes one percent of pay and matches any employee contribution up to an additional four percent of pay. For most employees hired after December 31, 1983, Customs also contributes the employer's matching share for Social Security.

Contributions of $82 million were made for fiscal year 1992 related to these plans.

Appropriated Funds with Treasury

Appropriated funds with Treasury represents the amount of Customs' unexpended spending authority as of September 30, 1992, that is unliquidated or is unobligated and has not lapsed, been rescinded, or been withdrawn.

Consolidated Statement of Reconciliation to Budget

The consolidated statement of reconciliation to budget reconciles total funded operating expenses as reported in the accompanying Consolidated Statement of Operations and Changes in Net Operating Position with outlays as reported on Customs' "Report on Budget Execution" (SF-133) for the year ended September 30, 1992. Differences in the two amounts are due to dissimilarities in accrual accounting used to prepare the consolidated financial statements and budgetary accounting used in preparing the SF-133.

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Comparative Presentation

This is the first year in which Customs' management prepared financial statements in accordance with the provisions of the CFO Act. Beginning in fiscal year 1993, comparative financial statements will be presented in order to provide a better understanding of and the significant trends in the financial position and results of operations of Customs.

2. Custodial Receivables:

Custodial receivables as of September 30, 1992, consist of the following (in thousands):

	Federal	Non-Federal	Total
Duties	$1,801	$ 748,400	$ 750,201
User fees	-	54,515	54,515
Excise taxes	-	69,434	69,434
Fines and penalties	-	26,070	26,070
Other	-	362	362
	1,801	898,781	900,582
Less amounts deemed uncollectible	-	72,687	72,687
Receivables, net	$1,801	$ 826,094	$ 827,895

The activity in the account for amounts deemed uncollectible for fiscal year 1992 is as follows (in thousands):

	Federal	Non-Federal	Total
Balance, October 1, 1991	$ -	$73,095	$73,095
Decrease for amounts deemed uncollectible	-	(408)	(408)
Balance, September 30, 1992	$ -	$72,687	$72,687

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Custodial Receivables (continued):

An aging of custodial receivables net of amounts deemed uncollectible as of September 30, 1992 is as follows:

	Aged Period					
	≤ 90 days	91 days-1 year	1-2 years	2-3 years	3+ years	Total
Duties	$653,193	$ 5,693	$4,514	$3,168	$32,641	$699,209
User fees	45,643	401	1,666	-	-	47,710
Excise taxes	55,677	819	49	4	270	56,819
Fines and penalties	3,754	20,041	-	-	-	23,795
Other	362	-	-	-	-	362
	$758,629	$26,954	$6,229	$3,172	$32,911	$827,895

Revenue generated from Customs' custodial activities is recognized when cash is collected. A receivable for fines and penalties is recorded when Customs has reached agreement with the violator as to the violation and the amount of the damages to be paid, where the Department of Justice has rendered a decision in favor of Customs and/or when the protest period has lapsed and Customs has the right to pursue legal remedies. During the year ended September 30, 1992, Customs assessed fines and penalties totaling approximately $4.5 billion in approximately 55,200 cases. These assessed amounts are based on the guidelines established in the laws and regulations Customs is charged with enforcing. The laws and regulations also allow for negotiation or mitigation to a lower fine or penalty amount to settle the case. During the year ended September 30, 1992, approximately 57,500 cases were settled resulting in $42.6 million of revenue. As of September 30, 1992, $23.8 million was recorded as a custodial receivable, net, for fines and penalties.

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. Forfeited Property and Currency:

Forfeited property and currency as of September 30, 1992, consist of the following (in thousands):

	Amount
Currency and other monetary instruments	$63,272
Property:	
General property	$ 2,709
Real property	4,200
Vessels	934
Aircraft	1,410
Vehicles	1,732
	$10,985
	$74,257

As of September 30, 1992, approximately $8.7 million or 79% of forfeited property was held by an outside contractor, with the remainder held by Customs.

The estimated value of destroyed forfeited property was approximately $17.5 million for fiscal year 1992. This estimated value is determined by the management of Customs and the outside contractor. Property destroyed consisted primarily of drugs and drug paraphernalia, and general property, such as illegal weapons and counterfeit merchandise. It is Customs' policy to not value drugs and drug paraphernalia as they will not be released into commerce or resold.

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Forfeited Property and Currency (continued):

Forfeited currency and other monetary instruments as of September 30, 1992, and an analysis of the changes for fiscal year 1992, are as follows (in thousands):

	Balance October 1, 1991	Forfeitures	Transferred to State/Local Federal or Foreign	Retained for Fund Operations	Balance Sept. 30, 1992
Currency and other monetary instruments	$94,667	$120,519	$78,327	$74,152	$62,707

For purposes of this schedule, currency and other monetary instruments on hand at the beginning and end of the fiscal year consists of forfeited currency held for evidence or approved for future transfer to state, local and other federal agencies or foreign countries. Transfers represent forfeited currency physically transferred during the fiscal year.

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Forfeited Property and Currency (continued):

Forfeited property as of September 30, 1992, and an analysis of the changes for fiscal year 1992, are as follows (in thousands):

	Balance October 1, 1991		Forfeitures	Sales	Transferred to State/Local Federal or Foreign	Destroyed	Balance September 30, 1992	
	At Net Realizable Value	At Value Estimated by Customs/Contractor						At Net Realizable Value
General Property	$20,331	$17,924	$46,245	$24,764	$11,790	$17,517	$ 8,098	$ 3,709
Real Property	6,314	5,569	5,381	4,261	1,537	0	5,112	4,300
Vessels	267	235	6,384	2,265	1,252	0	1,121	934
Aircraft	617	544	2,623	1,507	756	0	904	1,410
Vehicles	616	544	6,922	3,933	1,971	27	1,535	1,732
	$28,135	$24,816	$63,555	$36,710	$17,307	$17,544	$16,810	$10,985

	Sales		Transfers	
	At Estimated Value	At Net Realized Value	At Estimated Value	At Net Realized Value
General Property	$34,764	$ 3,498	$11,790	$2,412
Real Property	4,261	3,104	1,537	1,478
Vessels	2,265	1,480	1,253	1,175
Aircraft	1,107	1,210	756	1,186
Vehicles	3,933	2,557	1,971	2,346
	$36,710	$11,849	$17,307	$8,597

At the time of seizure, property is assigned an estimated value by Customs and/or the contractor. Many of these values are established by statute and are not intended to represent the amount expected to be received upon disposition. For statement purposes, the forfeited property is recorded at estimated net realizable value based on historical sales experience.

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Custodial Assets - Other

Custodial assets - other as of September 30, 1992 consist of the following (in thousands):

	Amount
Instruments held in lieu of surety	$3,398
Custodial Property (Note 8)	2,652
	$6,050

5. Seized Property and Currency:

Seized property and currency as of September 30, 1992, consist of the following (in thousands):

	Amount
Currency and other monetary instruments	$121,889
General property	168,268
Real property	93,969
Vessels	13,800
Aircraft	76,369
Vehicles	14,496
	$488,791

Seized property and currency result principally from Customs' criminal investigations and passenger/cargo processing. These assets are not legally owned by Customs until judicially or administratively forfeited and, accordingly, are not reflected as custodial assets in the Statement of Financial Position. Customs has fiduciary responsibility for these assets upon seizure. Seized property, substantially all of which is managed and maintained under a contract with an unrelated entity, is disclosed at a value estimated by Customs' officials and its contractor.

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Seized Property and Currency (continued):

Seized property and currency as of September 30, 1992, and an analysis of the changes for fiscal year 1992, are as follows (dollars in thousands):

	Balance, October 1, 1991	Additions	Deletions: On-Site Mitigations	Deletions: Other	Deletions: Forfeited	Balance Sept. 30, 1992
Currency and other monetary instruments	$105,473	$185,739	$ 4,899	$ 16,941	$147,683	$121,889
General property	234,378	188,041	30,398	181,403	42,350	168,268
Real property	20,197	81,572	300	388	7,112	93,969
Vessels	14,220	10,039	54	6,245	4,160	13,800
Aircraft	74,991	33,943	1,361	29,479	1,725	76,369
Vehicles	11,080	43,111	22,802	9,793	7,100	14,496
	$460,339	$542,445	$59,614	$244,249	$210,130	$488,791

The forfeited amount included in this schedule contains a $26,056 million difference when compared to the Forfeited Property and Currency Schedule (Note 3). This difference is attributable to timing differences between the recording of operational activity and accounting activity. Procedures are being performed to reconcile Customs systems.

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

6. Funds with Treasury and Cash:

Funds with Treasury and cash as of September 30, 1992, consist of the following (in thousands):

	Amount
Custodial Assets:	
Undistributed funds	$ 150,071
Other - suspense	63,635
Total undistributed funds with Treasury	213,706
Total fund balance with Treasury - refunds and drawbacks	9
Operating Assets/Agency Financial Resources:	
1992	97,235
1991	54,551
1990	18,434
1989	21,564
Multi-year	11,975
No-year	442,117
Merged-year	31,418
Other	3,926
Imprest cash balances	4,785
Total fund balances with Treasury and cash	687,005
Total funds with Treasury and cash	$ 900,720

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

7. Receivables from Reimbursable Services and User Fees:

Receivables from reimbursable services and user fees as of September 30, 1992, consist of the following (in thousands):

	Federal	Non-Federal	Total
Reimbursable services	$77	$ 4,267	$ 4,344
User fees	-	47,938	47,938
	77	52,205	52,282
Less amounts deemed uncollectible	-	7,789	7,789
Receivables from reimbursable services and user fees	$77	$44,416	$44,493

The activity in the account for amounts deemed uncollectible for fiscal year 1992 is as follows (in thousands):

	Federal	Non-Federal	Total
Balance, October 1, 1991	$ -	$ 933	$ 933
Increases for amounts deemed uncollectible	-	6,856	6,856
Balance, September 30, 1992	$ -	$7,789	$7,789

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

8. Property, Plant and Equipment:

Property, plant and equipment as of September 30, 1992, consist of the following (in thousands):

	Amount
Aircraft	$349,322
Other:	
Land	$ 74
Buildings	7,508
Other structures and facilities	34,435
Leasehold improvements	2,327
Equipment:	
Vehicles	71,458
Vessels	22,545
Other	166,050
Capitalized leased assets, principally equipment	49,573
Construction in progress	8,978
Total other property	362,948
Total property, plant and equipment	$712,270
Custodial	$ 2,652
Operating - aircraft	349,322
- other	360,296
Total operating property	709,618
Total property, plant and equipment	$712,270

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Property, Plant and Equipment (continued):

Property, plant and equipment as of September 30, 1992, and an analysis of the changes for fiscal year 1992, are as follows (in thousands):

Category	Balance, October 1, 1991	Additions	Deletions	Balance, September 30, 1992
Land	$ 74	$ -	$ -	$ 74
Buildings	7,489	70	51	7,508
Other structures and facilities	34,435	-	-	34,435
Leasehold improvements	1,505	822	-	2,327
Equipment:				
Vehicles	69,199	7,455	5,196	71,458
Vessels	24,692	1,141	3,288	22,545
Aircraft	285,020	64,365	63	349,322
Other	90,949	84,989	9,888	166,050
Capitalized leased assets, principally equipment	44,963	7,925	3,335	49,573
Construction in progress	-	8,978	-	8,978
	$558,346	$175,745	$21,821	$712,270
Custodial assets	$ 2,652	$ -	$ -	$ 2,652
Operating assets	555,694	175,745	21,821	709,618
	$558,346	$175,745	$21,821	$712,270

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Property, Plant and Equipment (continued)

An aging of property, plant and equipment as of September 30, 1992 is as follows (in thousands):

	Aged Period (by year of addition)					
	1992	1991	1990	1989	1988 & prior	Total
Land	$ -	$ -	$ -	$ -	$ 74	$ 74
Buildings	70	454	371	158	6,455	7,508
Other structures and facilities	-	-	-	23,193	11,242	34,435
Leasehold improvements	822	1,390	80	35	-	2,327
Equipment:						
Vehicles	7,455	12,757	12,260	13,117	25,869	71,458
Vessels	1,141	1,304	1,239	1,581	17,280	22,545
Aircraft	64,365	42,529	26,304	85,348	130,776	349,322
Other	84,989	11,077	8,379	9,434	52,171	166,050
Capitalized leased assets, principally equipment	7,925	4,816	18,059	8,015	10,758	49,573
Construction in progress	8,978	-	-	-	-	8,978
	$175,745	$74,327	$66,692	$140,881	$254,625	$712,270
Custodial assets	$ -	$ 2,652	$ -	$ -	$ -	$ 2,652
Operating assets	175,745	71,675	66,692	140,881	254,625	709,618
	$175,745	$74,327	$66,692	$140,881	$254,625	$712,270

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Property, Plant and Equipment (continued):

The estimated life and replacement cost (unaudited) by category of property, plant and equipment is as follows (in thousands):

	Estimated Replacement Cost						
	1992 and prior	1993	1994	1995	1996	1997 and Thereafter	Total
Land	$ -	$ -	$ -	$ -	$ -	$ 74	$ 74
Buildings	-	-	-	-	-	13,284	13,284
Other structures and facilities	-	-	-	-	-	35,903	35,903
Leasehold improvements	-	-	-	-	-	2,353	2,353
Equipment:							
Vehicles	7,741	12,162	9,895	14,639	13,278	20,761	78,476
Vessels	-	1,151	478	5,095	3,879	15,366	25,969
Aircraft	-	20,265	66	40,347	15,657	326,324	402,659
Other	36,305	11,478	8,450	7,861	10,859	81,963	156,916
Capitalized leased assets, principally equipment	-	-	-	465	1,960	32,415	34,840
Construction in progress	-	-	-	-	-	8,978	8,978
	$44,046	$45,056	$18,889	$68,407	$45,633	$537,421	$759,452

The above schedule was prepared using estimated 1992 replacement costs. The year of replacement was identified by assuming all assets will be replaced in the final year of its service life. Assets included in the 1992 and prior category continue to be used beyond their estimated service lives.

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

9. Accrued Refunds and Drawbacks:

Refunds include overpayments, duplicate payments, etc., to importers/exporters, while drawbacks are payments to importers for a portion of duties and taxes collected on imported goods where the goods are subsequently exported to a foreign market. Drawbacks consist of two types; accelerated and non-accelerated. Accelerated drawbacks are where the importer/exporter automatically receives the claimed return of previously paid duties and taxes when they file the claim for a drawback. As of September 30, 1992, the liability for accelerated drawbacks and refunds was approximately $34 million. This liability has been recorded on the Consolidated Statement of Financial Position. Non-accelerated drawbacks occur when the approval to apply for an accelerated refund or drawback has not been granted. In the non-accelerated situation the importer/exporter has three years to file the claim (verification of the import and subsequent export) and Customs has an additional two years to verify and approve the payment. Customs is not able to predict the dollar volume of the non-accelerated refunds and drawbacks. Any required payment will be in the normal course of business and will be paid from the congressional appropriation specifically received for refunds and drawbacks. During the fiscal year ending September 30, 1992, $775 million was expensed for refunds and drawbacks.

10. Changes in Custodial Net Position:

Changes in custodial net position for the year ended September 30, 1992, consisted of the following (in thousands):

	No-Year Appropriations	Future Funding Requirements
Balance, October 1, 1991	$33,036	$ (413)
Appropriations for fiscal year 1992	742,298	-
Net change for 1992	-	-
Appropriations expended for refunds and drawbacks	(775,325)	-
Future funding requirements expensed for fiscal year 1992	-	(34,031)
Total other changes	(33,027)	(34,031)
Balance, September 30, 1992	$ 9	$(34,444)

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

11. Accrued Payroll and Benefits:

Accrued payroll and benefits as of September 30, 1992, consist of the following (in thousands):

	Amount
Salaries	$67,837
FICA, unemployment and other payroll related taxes	2,489
Insurance	6,166
Retirement benefits	2,989
Other	1,961
	$81,442

12. Leases:

Operating Leases

Customs leases various facilities and equipment under leases accounted for as operating leases. Lease expense under these arrangements totaled $9.7 million for the year ending September 30, 1992. Assets held under these leases consist primarily of offices, warehouses, vehicles and other equipment.

As of September 30, 1992, future minimum lease commitments under noncancelable operating leases are as follows (in thousands):

Fiscal Year	Amount
1992	$5,480
1994	109
1995 and thereafter	45
Total future minimum lease commitments	$5,634

Much of the office space occupied by Customs is either owned by the Federal government or is leased by the General Services Administration from commercial sources. In either case, the space is assigned to Customs by GSA based upon current needs. Customs is not committed to continue to pay rent to GSA beyond the period occupied. However, it is expected that Customs will continue to occupy and lease office space from GSA in future years, and that the lease charges will be adjusted annually to reflect operating costs incurred by GSA. Lease expense paid to GSA during fiscal year 1992 was $98.8 million.

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Leases (continued):

Capital Lease Obligations

Customs has a number of capital lease agreements primarily involving mainframe computer equipment and other office equipment. All assets acquired under the capital lease agreements have been capitalized and the related obligations are reflected in the accompanying financial statements based upon the present value of the future minimum lease payments. As of September 30, 1992, the acquisition costs of the mainframe computer equipment and other office equipment still subject to lease payments are $35.1 million and $2.2 million, respectively. Certain of the leases are cancelable upon certain funding conditions. Lease terms generally range from 36 to 48 months.

Future minimum lease payments under the capitalized lease and the present value of the minimum lease obligation as of September 30, 1993, are as follows (in thousands):

Fiscal Year	Amount
1993	$ 9,169
1994	4,936
1995	3,831
1996	1,717
1997 and thereafter	48
Total future minimum lease payments	19,701
Less: Imputed interest	(2,708)
Total net present value of capital lease obligation	$16,993

Substantially, all of the net present value of capital lease obligations is expected to be funded from future funding sources and is presented as a component of unfunded operating liabilities on the Consolidated Statement of Financial Position.

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

13. Commitments and Contingencies:

Customs is a party to various administrative proceedings, legal actions, and claims brought by or against it. Any financial unfavorable court decisions will be funded from an appropriation within the Department of Justice or from the Customs appropriation for refunds and drawbacks except as noted in the following paragraphs. In the opinion of Customs' management and legal counsel, the ultimate resolution of these proceedings, actions, and claims will not materially affect the financial position or results of operations of Customs.

In July 1992 legal action was brought against Customs for eligibility of overtime compensation for certain grades of employees. Customs has agreed in principal to the claim and is in the process of determining the amount of compensation to be paid. It has not been determined whether the claim will be fully or partially funded by the Department of Justice or from Customs' appropriations.

Customs is also involved in an administrative proceeding where a certain grade of employees eligible to work in a "home to work" program were not adequately compensated. Currently the amount of the liability and whether payment will be fully or partially funded by the Department of Justice or from Customs' appropriation has not been determined.

DEPARTMENT OF THE TREASURY, UNITED STATES CUSTOMS SERVICE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

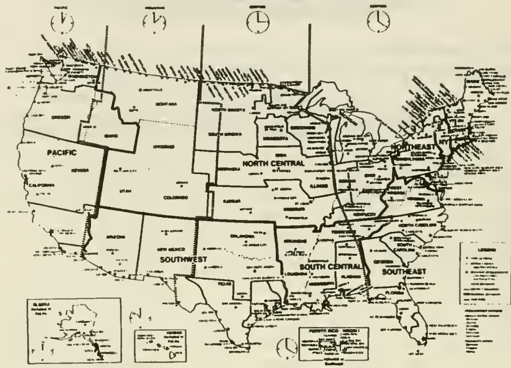
14. **Changes in Operating Net Position:**

Changes in operating net position for the year ended September 30, 1992 consisted of the following (in thousands):

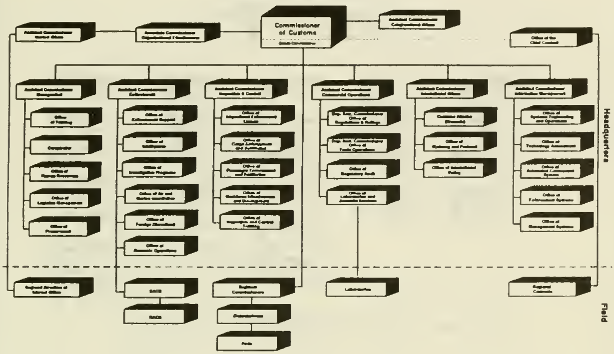
	Authorized Retained Capital	Appropriated Funds with Treasury: Unliquidated Obligations	Appropriated Funds with Treasury: No-Year and Other Appropriations	Appropriated Funds with Treasury: Reserve for Advances & Prepayments	Total Invested Capital	Cumulative Results of Operations	Future Funding Requirements	Total Other Changes
Balances as of October 1, 1991	$15,000	$360,618	$ 157,588	$21,121	$610,095	$169,221	$(95,731)	$1,237,912
Excess of financing over funded operating expenses	-	-	-	-	-	41,238	-	41,238
	15,000	360,618	157,588	21,121	610,095	210,459	(95,731)	1,279,150
Appropriations for fiscal year 1992	-	-	1,456,409	-	-	-	-	1,456,409
Appropriations expended for operations	-	-	(1,335,156)	-	(20,408)	-	-	(1,355,564)
Appropriations and other amounts expended for invested capital	-	-	(204,772)	-	201,943	-	2,829	-
Net change for 1992	(14,762)	826	(5,334)	(13,395)	-	-	-	(32,665)
Disposals of invested capital	-	-	-	-	(21,821)	-	-	(21,821)
Future funding requirements made	-	-	-	-	-	-	(24,535)	(24,535)
Future funding requirements expended	-	-	-	-	-		8,742	8,742
Total other changes	(14,762)	826	(88,853)	(13,395)	159,714	-	(12,964)	30,566
Balances as of September 30, 1992	$ 238	$361,444	$ 68,735	$ 7,726	$769,809	$210,459	$(108,695)	$1,309,716

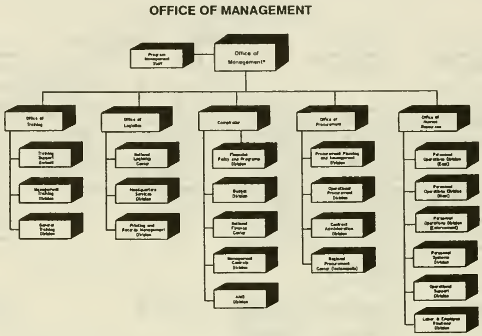
Supplemental Financial and Management Information

U.S. CUSTOMS SERVICE



U.S. CUSTOMS SERVICE





*The Assistant Commissioner for Management serves as the Chief Financial Officer for Customs.

Department of the Treasury
United States Customs Service

Supplemental Financial and Management Information

<u>REPORTABLE FUNDS</u>

<u>CUSTODIAL FUNDS</u>

<u>General Fund Receipt Accounts</u>

Budget Clearing Account
Proceeds of Sale, Personal Property, U.S. Customs Service
Deposit in Transit Differences (Suspense)
General Fund Proprietary Receipts , Not Otherwise Classified,
All Other (Charges for Testing, Inspecting & Grading,
Department of Health & Human Services)
Overtime Service, Federal Communications Commission
General Fund Proprietary Interest, Not Otherwise Classified
Fines, Penalties, and Forfeitures, Not Otherwise Classified
(Department of Health & Human Resources)
Duties on Imports
General Fund Proprietary Receipts , Not Otherwise Classified, All Other,
U.S. Customs Service
Excise Taxes
Miscellaneous Taxes, Not Otherwise Classified
Contributions to Conscience Fund
Fines, Penalties & Forfeitures, Agriculture Laws
Fines, Penalties & Forfeitures, Customs, Commerce and Antitrust Laws
Forfeitures of Unclaimed Money and Property
Fines, Penalties, and Forfeitures, Not Otherwise Classified
Overtime Service, Marine Inspection and Navigation, Treasury,
Transportation
Customs User Fee Account
Fines, Penalties, and Forfeitures, Immigration and Labor Laws
General Fund Proprietary Receipts, Not Otherwise Classified, All Other
(Consumer Product Safety Commission)
Other Repayments of Investment and Recoveries
Fines, Penalties, and Forfeitures, Not Otherwise Classified,
Dept. of Justice

<u>General Funds</u>

Refunds & Drawbacks, U.S. Customs Service, Indefinite

<u>Deposit Funds</u>

Suspense, Public Debt, Government Accounts Series
Duties Collected for the Virgin Islands Government,
U.S. Customs Service, Treasury Department
Suspense, U.S. Customs Service
Return of Deposits to Secure Payment of Fines and Passage Money,
Immigration and Naturalization Service
Assessments on Imports of Beef and Pork Products, Agricultural
Marketing Service

Department of the Treasury
United States Customs Service

Supplemental Financial and Management Information

REPORTABLE FUNDS

CUSTODIAL FUNDS (continued)

Special Funds

Customs Forfeiture Fund
Refunds, Transfers and Expenses of Operation, Puerto Rico, U.S. Customs Service
Refunds, Transfers and Expenses of Operation, Virgin Islands, U.S. Customs Service
Payments from Forfeited Assets, U.S. Customs Service
Customs Merchandise Processing Fee, U.S. Customs Service
30% of Customs Duties, on Wool, Reimbursement for Costs of National Wool Act
Import Duties on Arms and Ammunition
Immigration User Fees
Agricultural Quarantine Inspection User Fees Account, Animal and Plant Health Inspection Service

Trust Funds

Harbor Maintenance Trust Fund
Refunds, Transfers and Expenses, Unclaimed, Abandoned, and Seized Goods, U.S. Customs Service

AGENCY FUNDS

General Fund Receipt Accounts

Unavailable Check Cancellations and Overpayments (Suspense)
Undistributed and Letter of Credit Differences (Suspense)

General Funds

Salaries and Expenses, U.S. Customs Service
Operation and Maintenance, Facilities and Construction, U.S. Customs Service
Operation and Maintenance, Air Interdiction Program, U.S. Customs Service
Air and Marine Interdiction Programs Procurement

Special Funds

Customs Services at Small Airports
Customs User Fees Account, U.S. Customs Service

United States General Accounting Office

GAO

Report to the Commissioner, Internal Revenue Service

May 1993

FINANCIAL AUDIT

IRS Significantly Overstated Its Accounts Receivable Balance

GAO/AFMD-93-42

GAO United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

B-252330

May 6, 1993

Mr. Michael P. Dolan
Acting Commissioner
Internal Revenue Service

Dear Mr. Dolan:

This report presents the results of our review of accounts receivable at the Internal Revenue Service (IRS). We conducted this review as part of our financial statement audit of IRS pursuant to the Chief Financial Officers Act of 1990 (Public Law 101-576).

This report contains recommendations to you. As you know, the head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on these recommendations. You should send the statement to the Senate Committee on Governmental Affairs and the House Committee on Government Operations within 60 days of the date of this letter and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made over 60 days after the date of this letter.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Governmental Affairs; the Senate Committee on Finance; the House Committee on Government Operations; the House Committee on Ways and Means; the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations; the Subcommittee on Oversight, House Committee on Ways and Means; the Joint Committee on Taxation; the Secretary of the Treasury; the Director of the Office of Management and Budget; and other interested parties. Copies will be made available to others upon request.

This report was prepared under the direction of Jeffrey C. Steinhoff, Director, Civil Audits, who may be reached at (202) 512-9454 if you or your staff have any questions. Other major contributors are listed in appendix II.

Sincerely yours,

Donald H. Chapin

Donald H. Chapin
Assistant Comptroller General

Executive Summary

Purpose

The Internal Revenue Service's (IRS) reported gross accounts receivable have increased from $15.8 billion in 1980 to $110.7 billion as of September 30, 1991. This large balance implies that the American taxpayers owe a tremendous amount in unpaid federal taxes, and some have cited this figure as a potential source of government revenue. Primarily because of the high reported growth rate of IRS receivables, this issue has been designated by GAO and the Office of Management and Budget a high-risk area in the federal government, targeted for special management attention.

GAO reviewed the validity and collectibility of IRS reported accounts receivable as of June 30, 1991, in preparation for its audit of the IRS fiscal year 1992 financial statements. In accordance with authority granted by the Chief Financial Officers (CFO) Act of 1990, GAO elected to perform this audit.

Background

IRS, as part of the Department of the Treasury, is the nation's largest revenue collector. It is responsible for both routine tax collection and pursuing delinquent tax payments. For fiscal year 1991, IRS reported collections of about $1.1 trillion. Although most federal taxes are paid either before or at the time taxpayers file their returns, some are not. Unpaid assessments occur when (1) a tax return is filed without full payment, (2) an employer fails to deposit payroll taxes, (3) an audit identifies additional amounts owed, or (4) an estimated assessment is recorded for a nonfiler. Outstanding assessments are the basis for IRS reported accounts receivable.

In prior testimonies and reports, GAO questioned the reliability of IRS' reported accounts receivable balance. GAO reported IRS' estimate of gross receivables of about $111 billion and IRS' estimated collectible receivables of about $30 billion as of September 30, 1991. To complete its audit of IRS' first set of financial statements, GAO performed extensive tests as of June 30, 1991, to allow it to reliably estimate the accounts receivable balance and the amount of this balance that was collectible. GAO analyzed the IRS reported receivables by examining a random sample of 1,646 tax assessments that were outstanding as of June 30, 1991, the most recent data available at the time GAO's sample was drawn. GAO also evaluated IRS new methodology for estimating the collectibility of its receivables, which IRS first applied in its September 30, 1991, report to Treasury.

Results in Brief

GAO's analysis showed that the IRS reported gross receivables balance for June 30, 1991, was overstated by as much as $39.4 billion and that about two-thirds of what was owed was not likely to be collected. Because the composition of IRS gross receivables changed little during the 3 subsequent months, GAO believes that the overstatement is also reflected in the IRS September 30, 1991, balance. The following table compares the projected results of GAO's analysis with IRS reported balances for June and September 1991.

Table 1: Comparison of GAO's Analysis With the IRS Reported Balances[a]

Dollars in billions

	GAO's analysis of IRS 6/30/91 balance	IRS reported balance as of 6/30/91	IRS reported balance as of 9/30/91
IRS gross reported receivables	$104.7	$104.7	$107.0
Invalid receivables	(39.4)	[b]	[b]
Subtotal	65.3	104.7	107.0
Uncollectible	(46.6)	(38.4)	(78.6)
Net collectible receivables	$ 18.7[c]	$ 66.4[c]	$ 28.4[c]

[a]All three sets of figures are for the IRS two largest account files, which cover about 96 percent of the IRS total gross reported receivables.

[b]Not computed.

[c]A significant portion of the net collectible receivables is not currently collectible because it is attributable to deferred estate taxes and installment payments.

IRS overstated its gross receivables primarily because it included duplicate and insufficiently supported assessments that it had recorded as part of its efforts to identify and collect taxes due. These and many erroneous assessments were not valid receivables for financial reporting purposes and should not have been included in the reported balances.

In addition, IRS estimates regarding the collectibility of its receivables were unreliable. Its June estimate did not involve any substantive analysis of collectibility, and the methodology used to develop its September estimate, while involving a more extensive analysis, was also flawed. In addition to including invalid receivables in its September analysis, IRS relied solely on collection experience and did not group assessments according to their collection risk nor consider the taxpayers' current ability to pay.

IRS figures have been used in congressional deliberations regarding the impact increased collections could have on reducing the deficit, assessing receivables growth, evaluating IRS enforcement and collection performance, and making decisions regarding IRS staffing needs. Further, some taxpayers may perceive that IRS efforts to collect taxes are not equitable based on the disparity between IRS gross receivables and amounts expected to be collected. This, in turn, could affect voluntary compliance with the tax laws. Also, GAO's estimate that most of the IRS valid receivables are not likely to be collected is a reflection, in part, of the IRS cumbersome collection process, as previously reported by GAO. More reliable information on receivables could allow IRS to more effectively allocate resources, determine staffing levels, and measure enforcement and collection performance.

Principal Findings

IRS Overstated Its Gross Receivables

Based on GAO's analysis, IRS gross receivables balance as of June 30, 1991, was overstated by as much as $39.4 billion because it was based on data maintained by a system that had been developed to support IRS enforcement and collection efforts rather than financial reporting and other financial management needs. IRS systems were not designed to distinguish between assessments that represent valid receivables and those that do not. As a result, IRS reported balances included (1) multiple assessments against individuals made in an attempt to collect a business' tax liability and (2) estimated assessments against nonfilers based on limited data. In addition, many assessments were erroneous, due to IRS and taxpayer errors.

The lack of complete and accurate data on IRS receivables hinders its ability to develop the best collection strategies, put resources to their best use, and measure its performance. Also, high error rates and inefficient systems create additional work for both IRS and taxpayers. Further, the inaccurate information provided Members of Congress and the public with an exaggerated idea of the potential for increasing collections to reduce the deficit.

IRS has several accounting system improvement projects under way that, if successfully completed, will reduce erroneous assessments and improve system efficiency. However, as currently planned, these efforts are not intended to provide IRS the capability to readily identify the assessments that should be included as receivables in its financial reports. Also, these efforts continue to be conducted under the Assistant Commissioner for Returns Processing, whose primary responsibility is processing tax returns, an operating responsibility. Although the IRS CFO is responsible for financial management, the CFO does not have the authority to ensure that IRS systems provide needed data.

IRS Methodology for Estimating Collectibility Is Not Reliable

Reliably estimating an allowance for uncollectible receivables requires consideration of both historical collection experience and current economic conditions since collectibility may change as economic conditions change. Also, according to a standard recently recommended by the Federal Accounting Standards Advisory Board, such an analysis should be performed on groups of accounts with similar collection risk characteristics and should include an evaluation of individual accounts to determine the taxpayers' current ability to pay.

IRS acknowledged that, prior to its September 30, 1991, report to Treasury, it did not have a meaningful methodology for estimating the uncollectible portion of its receivables balance. The methodology that IRS first applied in its September 30, 1991, report to Treasury, while representing an extensive analysis of receivables, was also flawed. In addition to basing its assessment on its overstated gross receivables balance, IRS did not analyze individual taxpayer accounts to determine the taxpayers' current ability to pay. Further, although IRS developed historical collection rates for groups of assessments, the assessments within these groups did not have similar collection risk characteristics, and IRS did not consider current and forecast economic conditions.

Recommendations

GAO recommends that the Commissioner of the Internal Revenue Service provide the IRS Chief Financial Officer authority to ensure that the IRS accounting system development efforts meet its financial reporting and other financial management needs. At a minimum, the Chief Financial Officer's approval of related system designs should be required. In addition, GAO recommends that the Commissioner direct the Chief Financial Officer to

- develop a strategy for distinguishing between assessments that should be included in the receivables balance and those that should not and include only valid receivables in the balances reported in IRS financial statements, and

- modify IRS methodology for assessing the collectibility of its receivables by (1) including an analysis of individual taxpayer accounts to assess their ability to pay and (2) basing group analyses on (a) categories of assessments with similar collection risk characteristics, (b) current and forecast economic conditions, and (c) historical collection data.

Agency Comments

In its response, IRS took no exception to GAO's findings and supported the recommendations. IRS stated that it is moving forward to place responsibility for the entire revenue accounting function under the Chief Financial Officer. Also, IRS stated that it has made significant strides in evaluating its assessments and in excluding certain assessments from its accounts receivable. Further, IRS said that it is conducting a statistical study of its accounts receivable in order to determine their collectibility. GAO plans to evaluate the effectiveness of these efforts as part of its ongoing audit of the IRS financial statements. The IRS comments are discussed and evaluated in chapters 2 and 3 and are included in appendix I.

Contents

Abbreviations

BMF	business master file
CFO	Chief Financial Officer
FASAB	Federal Accounting Standards Advisory Board
FTD	Federal Tax Deposit
GAO	General Accounting Office
IMF	individual master file
IRS	Internal Revenue Service
OMB	Office of Management and Budget

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Chapter 1

Introduction

This report discusses the validity and collectibility of IRS reported gross accounts receivable, which since 1991 have exceeded $100 billion. Because of the large size and rapid growth of IRS accounts receivable since 1980, we and the Office of Management and Budget (OMB) have designated this issue as a high-risk area, targeted for special management attention.

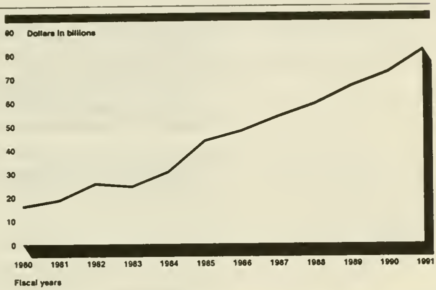
Our review of IRS accounts receivable is an integral part of our audit of IRS financial statements. IRS is 1 of 10 federal agencies required to prepare financial statements and have them audited by June 30, 1993, as a pilot project under the Chief Financial Officers (CFO) Act of 1990 (Public Law 101-576). The CFO Act establishes a blueprint for effective financial management reform that includes a strong financial management leadership structure, the requirement for a long-range financial management improvement plan, audited financial statements, development of performance and cost data, and integrated financial management systems. As authorized in the act, we elected to perform the financial statement audit of IRS for the fiscal year ending September 30, 1992.

Background

IRS, as part of the Department of the Treasury, is responsible for both routine tax collection and pursuing delinquent tax payments. IRS is the largest revenue collector for the federal government, reporting tax collections of about $1.1 trillion for fiscal year 1991.

IRS gross reported accounts receivable have increased from $15.8 billion in 1980 to $110.7 billion in 1991. This implies that taxpayers owe a significant amount in unpaid taxes, and some have cited the receivables balance as a potential source of federal revenue. IRS has stated that this dramatic growth is attributable primarily to its aggressive enforcement efforts, changes in the way it reported accounts receivable, economic conditions, and legislative changes. Also, a large part is due to IRS' inclusion of accrued interest and penalties in the accounts receivable balance beginning in 1989. The fiscal year 1991 balance of $110.7 billion included about $29 billion in accrued interest and penalties. However, even when accrued interest and penalties are excluded, IRS accounts receivable balance has increased fourfold since 1980, as shown in figure 1.1.

Figure 1.1: IRS Year-End Accounts Receivable Balances for Fiscal Years 1980 Through 1991 (Excluding Accrued Interest and Penalties)



Although most federal taxes are paid either before or at the time taxpayers file their returns, some are not. Unpaid assessments occur when (1) a tax return is filed without full payment, (2) an employer fails to deposit payroll taxes,[1] (3) an audit identifies additional amounts owed, or (4) an estimated assessment is recorded for a nonfiler. Once an assessment is created, it remains in IRS accounting records until paid, canceled, or the applicable statute of limitations for collection has expired.[2] These assessments are the basis for IRS reported accounts receivable.

IRS records assessments when taxes due are identified by one of its 10 service centers or 63 district offices. The majority of these assessments are entered on magnetic tapes which are then shipped to the IRS Computer Center in Martinsburg, West Virginia, for recording into IRS Master File System. This system maintains detailed data on taxes paid and owed by millions of taxpayers.

[1]Payroll taxes include the employers' share of employment taxes and the income and social security taxes withheld by employers from employees' salaries and wages, and federal unemployment taxes.

[2]The collection statute of limitations (section 6502 of the Internal Revenue Code) provides a specific period after assessment for IRS to collect delinquent taxes. Until November 1990, the collection period was generally 6 years. The Omnibus Budget Reconciliation Act of 1990 extended the collection period to 10 years.

The Master File System, which accounts for approximately 96 percent of IRS gross receivables balance, consists of three major files. The two largest are the individual master file (IMF) and business master file (BMF). The third file—the individual retirement account file—contains data on individual retirement accounts and pension plans. IRS maintains the remaining 4 percent of its gross receivables balance in a system called the nonmaster file, which is used to account for unusual returns and assessments that require special attention.

Data in the Master File System are the basis for IRS quarterly reports to Treasury, which include a schedule of accounts receivable. The Master File System data will also provide most of the support for the accounts receivable balance in the IRS September 30, 1992, financial statements.

The IMF and BMF included 17 million tax assessments as of June 30, 1991.[3] More than half of these assessments were valued at less than $1,000 each and together accounted for only 3 percent of the outstanding receivable balance. Table 1.1 shows the dollar value of IMF and BMF tax assessments by account size as a percent of total IMF and BMF tax assessments.

Table 1.1: Number and Dollar Value of Tax Assessments as of June 30, 1991

Value of receivables in individual assessments	Percent of tax assessments	Percent of dollar value
$1 to $999	51.3	3.0
$1,000 to $9,999	38.9	21.7
$10,000 to $99,999	9.2	37.1
$100,000 and above	0.6	38.2

In the late 1980s, in response to heightened interest in its growing receivables balance, IRS began analyzing its receivables to better understand their characteristics and estimate their collectibility. Although in 1989 IRS began designating in its reports to Treasury a segment of its accounts receivable balance as uncollectible, it did not formally adopt a methodology for estimating the collectibility of its receivables until 1991. IRS first report to Treasury that incorporated this methodology was for September 30, 1991.

[3]Each assessment was recorded in a separate taxpayer module which reflected tax data for one type of tax and one tax period. Typically each taxpayer's account consists of several modules: one or more for each tax year. For example, in a given year a typical business taxpayer files three types of tax returns: one annual corporate tax return, four quarterly employees' withholding tax returns, and one annual federal unemployment tax return. Such a taxpayer would have one account but six tax modules.

Objectives, Scope, and Methodology

We reviewed IRS accounts receivable in preparation for our audit of IRS fiscal year 1992 financial statements. Our specific objectives were to

- determine the validity of IRS reported gross accounts receivable balance as of June 30, 1991, and the potential effect of related accounting improvement efforts, and
- evaluate IRS methodology for calculating its allowance for doubtful accounts, first applied in September 1991.

To assess the validity of IRS gross accounts receivable balance, we investigated a random sample of 1,646 tax assessments valued at $49.2 million that were outstanding as of June 30, 1991. These were the most recent data available at the time our sample was drawn. Our sample was selected from the IMF and BMF which accounted for $104.7 billion of IRS gross receivables balance as of June 30, 1991. The universe from which our sample was drawn did not include $4.0 billion in receivables maintained in the individual retirement account file and the nonmaster file. Thus, our sample allows us to project our results to only the $104.7 billion in receivables maintained in the IMF and BMF as of June 30, 1991.

As with any statistical analysis, the results are subject to some uncertainty, or sampling error, because only a portion of the universe was selected for review. The sampling method used allowed us to estimate the value of invalid, valid, uncollectible, and collectible receivables, at a 95 percent confidence level.

Our projections are expressed as point estimates that fall within confidence intervals. This means that if you were to determine an estimate for 100 different random samples of the same size from this population, 95 out of 100 times, the estimate would fall within the confidence interval. In other words, the true value is between the lower and upper limits of the confidence interval 95 percent of the time.

To determine the validity of our sampled assessments, we examined taxpayers' transcripts and case files to determine why a receivable was created, whether IRS had sufficient reliable information to determine the amount owed, if IRS had included the assessment more than once in its gross receivables balance, and if the assessment had been adjusted or canceled because it was erroneous. A taxpayer case file typically contains the revenue officer's notes, the taxpayer's return, the taxpayer's statement of financial condition, and other pertinent information.

To assess the potential effect of IRS improvement efforts, we reviewed IRS financial management system plans to determine if they adequately addressed deficiencies that we identified. We also discussed these plans with IRS officials.

To assess the IRS methodology for calculating its allowance for doubtful accounts, we examined the documentation supporting the IRS estimate of collectible receivables, which was applied for the first time in its September 30, 1991, report to Treasury. We compared the IRS methodology to the criteria established in Title 2 of GAO's Policy and Procedures Manual for Guidance of Federal Agencies and to the more detailed guidance provided in the Federal Accounting Standards Advisory Board's (FASAB) proposed standard, "Accounting for Selected Assets and Liabilities." We also met with cognizant IRS officials to gain a thorough understanding of the data and procedures used.

We then developed our own estimate of uncollectible accounts by determining the collectibility of the assessments in our sample that we had determined were valid for financial reporting purposes. To do this, we examined IRS case file records that showed each taxpayer's income and assets, earnings potential, outstanding amounts owed, payment history, and any other relevant information in the file that bore on the taxpayer's ability to pay. We also considered the extent of IRS efforts to collect the assessments.

To verify that our assessment of the collectibility of IRS June 30, 1991, accounts receivable balance could be used to evaluate the reliability of IRS September 30, 1991, assessment, we compared the size and composition of the two balances to determine if they were substantially the same. We analyzed detailed accounts receivable records as of June 30 and September 30, 1991, and determined the extent of new receivables recorded during that period and the extent of receivables that were either paid or otherwise removed during that period. We found that over 90 percent of the receivables balance on September 30, 1991, was attributable to receivables that were also in the June 30, 1991, balance.

To ensure that our collectibility estimate was based on all available data and that our judgments regarding collectibility were reasonable, we interviewed IRS field officials and let them review our determinations for all sampled assessments. In some instances, IRS provided additional information which we considered. Generally, these officials agreed with our final determinations regarding the collectibility of individual assessments.

The Internal Revenue Service provided written comments on a draft of this report. These comments are presented and evaluated in chapters 2 and 3, and are included in appendix I.

We performed our work at IRS headquarters in Washington, D.C., and at selected IRS regional offices and service centers. Our work was performed from December 1991 through December 1992 in accordance with government auditing standards.

The IRS Receivables Balance Is Based on Data Maintained for Collection Purposes

Based on our analysis of 1,646 randomly selected assessments that IRS reported as receivables as of June 30, 1991, we estimate that only \$65.3 billion[1] of the \$104.7 billion gross receivables balance from the individual master file and business master file represented valid receivables that should have been included in IRS financial reports. The approximate \$39 billion overstatement of IRS gross receivables occurred primarily because IRS reported balance included assessments that were recorded to support enforcement actions and collection activities but which did not represent valid receivables from a financial reporting perspective and, therefore, should not have been included in the receivables balance.[2]

IRS systems were designed to support enforcement and collection activities, not to support financial reporting and other financial management needs, and they cannot distinguish between assessments that represent valid receivables and those that do not. This deficiency can adversely impact collection activities as well as financial report accuracy. Although IRS is working to improve these systems, its current efforts are not designed to determine which assessments should be included in its receivables balance. In addition, these efforts are not subject to approval by the IRS Chief Financial Officer (CFO), who is supposed to ensure that IRS agencywide financial reporting needs are met.

Receivables Balance Included Assessments That Did Not Represent Valid Receivables

IRS gross accounts receivable balance was overstated primarily because IRS reported all assessments rather than reporting only those that represented valid receivables. As a result, duplicate and inadequately supported assessments made to enforce tax laws were included in the balance even though they did not represent valid receivables. In addition, IRS gross receivables balance included erroneous assessments made as a result of IRS or taxpayer mistakes. The overstatements resulting from including these invalid amounts were magnified by the fact that IRS also automatically accrued interest and penalties on them. Based on the results of our sample, we estimate that about 38 percent, \$39.4 billion,[3] of the IRS gross accounts receivable balance as of June 30, 1991, did not represent

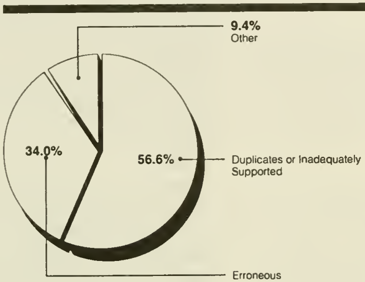
[1] The range of our confidence interval, at a 95 percent confidence level, is that the actual amount of valid accounts receivable as of June 30, 1991, was between \$51.7 billion and \$76.5 billion.

[2] Throughout this report, we refer to invalid receivables as those assessments which should not be included for financial reporting purposes. However, we recognize that IRS needs to account for those assessments for enforcement and compliance purposes.

[3] The range of our confidence interval, at a 95 percent confidence level, is that the actual amount of invalid accounts receivable as of June 30, 1991, was between \$28.2 billion and \$53.0 billion.

valid receivables and, thus, should not have been included. Figure 2.1 shows the percentage of the value of the assessments in our sample that we determined were not valid receivables because they were (1) duplicate or inadequately supported, (2) erroneous, or (3) due to miscellaneous other causes.

Figure 2.1: Reasons Sampled Assessments Did Not Represent Valid Receivables (as a Percent of Dollar Values)



Enforcement Actions Have Resulted in Inclusion of Duplicates and Inadequately Supported Assessments

The majority, 56.6 percent, of the invalid receivables' value in our sample was either a result of (1) multiple assessments against individuals made in an attempt to collect a business tax liability or (2) inadequately supported assessments. For example, when a company does not pay IRS the taxes that it has withheld from its employees' wages, IRS assesses the business and each of its responsible officers individually for the full amount owed. To illustrate, IRS may record assessments against several individuals for $1,000 each in an effort to collect one $1,000 receivable from a business. While these assessments are an appropriate and effective enforcement tool, IRS officials were aware that including all of these assessments overstated the June 30, 1991, receivables balance. However, IRS financial management systems were not then capable of identifying and deleting the duplicate amounts, a necessary step for accurate financial reporting as well as proper financial management.

Other invalid receivables represented amounts that were not supported by sufficient reliable information and, therefore, should not have been included as accounts receivable in external financial reports. IRS had estimated that these amounts were due from taxpayers under its "substitute for return" program for individual nonfilers and the "6020b" program for business nonfilers. Under these programs, IRS contacts individuals and businesses that have received taxable income but have not filed tax returns. If they do not respond, for enforcement purposes, IRS independently prepares their tax returns and records the related assessments. These assessments are generally based on very limited information, such as the Wage and Tax Statement (W-2 form) for individuals. In addition, IRS assesses the maximum amount of tax that may be owed. For example, when calculating the tax for a substitute return for an individual, IRS typically assumes one personal exemption (single filing status) and uses the standard deduction to ensure that the assessment is not understated.

To illustrate, in November 1990, IRS prepared a "substitute" tax return for an individual taxpayer for tax year 1987 using the above assumptions, assessed the taxpayer $6,867 and included that amount in its accounts receivable balance at June 30, 1991. In September 1991, the taxpayer filed a return showing the actual personal exemptions and other deductions for tax year 1987, which resulted in a refund of $128. While preparation of the substitute return was an appropriate enforcement tool that prompted the taxpayer to comply with the law by filing a tax return, in this case, it resulted in an overstatement of $6,867 in IRS accounts receivable.

IRS and Taxpayer Mistakes Resulted in Erroneous Assessments

A substantial amount, 34.0 percent, of the value of the invalid assessments that we identified in our sample were invalid due to IRS and taxpayer errors. In some cases, these errors were discovered by IRS and the related assessments canceled after the date of our sample. However, during the period between the date they were recorded and the date they were canceled, they were included in IRS gross receivables, thus overstating the balance. Identifying and correcting errors, which are often made by taxpayers, is a continuing process for IRS. On any given date, IRS receivables balance is likely to contain errors that may subsequently be corrected.

For example, as of June 30, 1991, IRS records indicated that an assessment of $38,736 remained unpaid. This resulted from a taxpayer error when IRS recorded tax data to the wrong taxpayer's account because the wrong name and address label had been placed on the tax return. When the taxpayer provided information to IRS explaining the error, IRS made the appropriate adjustments. In another case, we identified an unpaid assessment of $256 that existed because IRS had not recorded a payment for employee withholding taxes to a taxpayer's account. Subsequently, the taxpayer provided a copy of the canceled check and federal tax deposit coupon which showed that IRS had processed the check. IRS agreed that an error had been made and adjusted the taxpayer's account, which eliminated the incorrect $256 assessment.

Based on the information contained in the taxpayer files we examined, we could not precisely determine the causes of many of the errors we identified. However, numerous GAO and IRS internal audit reports and testimonies have identified specific causes of errors and recommended corrective actions. For example, IRS has reported and has taken steps to identify many errors that have been caused by its cumbersome paper-based Federal Tax Deposit (FTD) System, which employers use for reporting and paying employee taxes.

Other Causes of Invalid Receivables

About 9 percent of the value of invalid receivables in our sample was due to miscellaneous other causes. Most of these involved expedited refunds to taxpayers. IRS expedites refunds in certain situations, such as those involving financial hardship or lost refund checks. Expedited refunds are processed manually, outside of the normal process. For this reason, they are sometimes recorded in the Master File System before the related tax return is recorded or, in the case of replacement refunds, before the original refund has been canceled. When this occurs, the Master File System shows that IRS has either advanced funds to a taxpayer or appears to have duplicated a refund. Although this serves as a control to ensure that the tax return is recorded or the original refund is canceled, it also creates a receivable. For example, in June 1991, IRS issued a manual refund for $494 to a taxpayer before the tax return was filed. This amount was included in the IRS June 30, 1991, receivables, thus contributing to the overstated balance. The receivable was eliminated when the tax return was recorded in July 1991.

Lack of Emphasis on Financial Reporting and Inadequate Systems Have Affected Report Accuracy

IRS overstated its receivables primarily because its emphasis has traditionally been on supporting enforcement actions and monitoring the status of assessments in the collection process. As a result, the information on its receivables that it has used for financial management purposes and has reported to Treasury and the Congress has been inaccurate, and information that may have facilitated collection efforts has not been available. IRS ability to analyze and correctly report its receivables has further been hampered by its outdated inefficient automated systems.

Inaccurate Reports to Treasury

Although IRS has reported quarterly to Treasury on its financial condition and operations, until the mid-1980s, when the receivables balance began to grow significantly, this information received little scrutiny from external users. IRS placed little emphasis on ensuring its financial reporting accuracy, and IRS financial systems were not designed to distinguish between assessments that represented valid receivables and those that did not.

Although IRS began to analyze its receivables in the late 1980s in order to better understand their characteristics, during fiscal year 1991, it continued to develop its financial reports by summarizing all outstanding assessments without identifying those that represented multiple assessments for the same tax liability or those that were inadequately supported. IRS officials told us that they recently developed a way to identify some of these invalid receivables and, thus, may be able to improve the accuracy of the gross receivables balance reported in IRS fiscal year 1992 financial statements. Although, we have not evaluated these efforts, we will review and monitor IRS efforts to improve its receivables reporting as part of our ongoing financial statement audit.

Unreliable Information on Receivables Hampers IRS Operations and May Mislead the Congress and Taxpayers

Reliable information on receivables is important to external users, such as the Congress and the taxpayers, as well as IRS' own managers. IRS figures have been used in congressional deliberations regarding the potential for increasing collections to reduce the deficit, assessing receivables growth, evaluating IRS performance in enforcing tax laws and collecting taxes due, and making decisions regarding IRS staffing needs.

Taxpayers may interpret the disparity between IRS gross receivables and amounts expected to be collected as an indication that IRS efforts to collect taxes are not equitable, because some taxpayers are not meeting their tax obligations. Also, taxpayers' confidence in IRS may be diminished if they receive erroneous tax delinquency notices. This, in turn, could affect voluntary compliance with the tax laws.

IRS' own managers need reliable information on receivables to allocate resources to their most productive use, determine staffing levels, and ensure that resources are not wasted on erroneous assessments. High error rates and inefficient systems create additional work for both IRS and taxpayers. Also, better information on assessments that have been recorded for enforcement purposes, as well as those that represent valid receivables, would allow IRS to more reliably assess its enforcement and collection performance. The lack of data reliability and its potential affect on collectibility is further discussed in chapter 3.

Automated Systems Are Outdated and Inefficient

The systems that IRS relies on are outdated, inefficient, unintegrated, and error prone, factors which further hamper IRS' ability to analyze and properly report on its receivables balance. For example, the IRS Master File System stores data associated with millions of taxpayer accounts on magnetic tape, which is less efficient to maintain and use than other electronic media, such as computer disks. Because the data on tapes can only be processed sequentially rather than randomly, updating these data or extracting certain data elements requires IRS' voluminous files to be read in their entirety, resulting in significant effort and time.

We also found that the general ledgers maintained at the IRS 10 service centers still had deficiencies that we had reported on in 1988.[4] For example, the general ledgers were not integrated with the IRS Master File System and did not support accurate reporting of accounts receivable and other information. These deficiencies are significant since an agency's general ledger is to serve as a primary financial control by summarizing detailed data maintained in subsidiary accounts. Consequently, the information contained in the general ledger should be traceable to the subsidiary systems. In addition, an agency's financial statements are to be based on general ledger balances.

Each IRS service center's general ledger is intended to summarize the individual master file accounts for which it has collection responsibility. However, the data maintained in the general ledgers regarding receivables are incomplete because accruals for interest and penalties are not

[4] Internal Revenue Service: Need To Improve the Revenue Accounting Control System (GAO/IMTEC-88-41, June 17, 1988) and Managing IRS: Actions Needed To Assure Quality Service in the Future (GAO/GGD-89-1, Oct. 14, 1988).

recorded in the general ledger, even though they are separately computed and reported by IRS in its external reports. Also, because the telecommunication links between the Master File System and the general ledgers are limited, extensive manual data entry is needed to transfer summary data to the general ledgers.

Further, IRS systems have not been designed to report basic information supporting the general ledger balances or to perform analyses needed for financial reports. For example, IRS could not readily provide a record of the detailed transactions that supported its general ledger balances for revenue. IRS officials told us that they would have to develop a special computer program to obtain such records, an effort they estimated would take about 10 months. Also, the general ledgers were not capable of summarizing receivables according to their age, an analysis that is key to assessing collectibility and required for IRS' Treasury reports. As a result, IRS developed a separate receivables data base to perform such analyses. However, IRS has had to implement additional controls, such as manual reconciliations, to ensure that the data maintained in both sets of records were accurate.

Improvement Efforts Continue to Neglect Financial Reporting

IRS has several accounting system improvement projects under way that are intended to improve IRS' ability to update and extract more efficiently accounts receivable data and reduce erroneous assessments. However, as currently planned, these efforts will not allow IRS to readily distinguish between valid and invalid receivables for financial reporting purposes. Also, these efforts are not subject to the approval of the CFO, the key financial manager in IRS. As a result, IRS may continue to (1) have difficulty in reporting only valid receivables and (2) place inadequate emphasis on its financial reporting responsibilities.

Improvement Efforts Will Not Provide Capability to Distinguish Between Valid and Invalid Receivables

During fiscal year 1992, IRS had the following revenue accounting system improvement efforts under way, which directly affect its receivables accounting. These efforts are in various stages of development and will take a number of years to complete.

- The Revenue Accounting Control System, which maintains the IRS general ledger, is to be replaced with a more modern system by the year 2000. The new system is to be integrated with other systems to reduce manual intervention and, thus, improve the timeliness of data transmissions and reduce errors.

- The Master File System is to be transferred from magnetic tape to direct access media, such as magnetic disk. This is to provide easier and faster access to taxpayer account data and facilitate IRS' ability to extract data for special analyses, such as those needed to estimate the amount of uncollectible receivables.
- The Federal Tax Deposit System is being redesigned to capture and process data more efficiently and reduce errors, primarily by reducing the number of paper-based transactions.

These efforts may improve IRS' ability to retrieve, analyze, and report some financial data and reduce some errors. However, they will not enhance IRS' ability to differentiate between assessments that are valid receivables and those that are not. To overcome this deficiency, we estimated the amount of IRS assessments that should be included in its reported receivables balance by examining a random sample of assessments and projecting the results.

Revenue Accounting Is Not Under CFO's Control

Although the IRS CFO is responsible for financial reports, the CFO does not have the authority needed to ensure that these reports are accurate and developed in accordance with applicable accounting standards. IRS established a CFO in 1989 and, in 1990, established the position of Assistant Commissioner for Finance/Controller to assist the CFO in overseeing financial management matters. The Assistant Commissioner position was filled by a person who has extensive financial management experience in the federal government.

However, during 1991 and 1992, the CFO's direct control over accounting was largely limited to IRS administrative functions and did not encompass tax revenue and receivables. Although responsible for compiling IRS fiscal year 1992 financial statements, the CFO had little control over how the supporting data related to revenue, including receivables, was maintained and reported. In addition, although during 1992, the IRS CFO assumed an advisory role in system development efforts, the CFO's approval of related plans and implementation efforts was not required.

The CFO Act of 1990, in addition to requiring certain agencies to develop financial statements and have them audited, required each of the 23 major departments to establish a CFO with comprehensive responsibilities for overseeing the agencies' financial management organization and systems. IRS is not required to have its own CFO since it is part of the Department of the Treasury, which is one of the 23 major departments designated to have a CFO. However, Treasury's plan for implementing the act, submitted to OMB in 1991, states that Treasury's long-term goal is to have the financial management organizations at all Treasury bureaus, including IRS, mirror its own CFO structure. Under Treasury's plan, CFOs report directly to the agency head and hold a wide range of financial management responsibilities, including

- establishment and enforcement of financial management, accounting, and internal control policies for both administrative and program areas; and
- review and approval of all financial management system changes.

OMB's February 27, 1991, Guidance for Preparing Organization Plans Required by the CFO Act (M-91-07) provides additional guidance on the responsibilities that CFOs, whose offices were established by the act, are expected to assume. Specifically, this guidance says that agency CFOs shall oversee all financial management activities relating to programs and operations of the agency and develop and maintain an integrated agency accounting and financial management system, including financial reporting and internal controls. OMB requires that CFOs be provided with the authority to

- manage directly, and/or monitor, evaluate, and approve, the design, budget, development, implementation, operation, and enhancement of agencywide and agency component accounting, financial and asset management systems (which includes debt collection);
- approve designs for other information systems that provide financial and/or program performance data used in financial statements, solely to ensure that CFO needs are met;
- ensure that program information systems provide financial and programmatic data (including program performance measures) reliably, consistently and promptly to agency financial management systems; and
- evaluate, where appropriate, the installation and operation of such systems.

In an April 1991[5] report, we stated our belief that the IRS Assistant Commissioner for Finance/Controller was the key to the success of IRS financial management improvement efforts and recommended that the IRS Commissioner transfer responsibility for revenue accounting activities to the Controller, who reports directly to the CFO. In response, IRS stated that (1) the Controller would be responsible for establishing standards for bc

[5] Managing IRS: Important Strides Forward Since 1988 But More Needs to Be Done (GAO/GGD-91-74, Apr. 29, 1991).

revenue and administrative accounting systems and (2) an accounts receivable executive officer would report directly to the CFO to provide a top-level focus on accounts receivable and coordinate related activities. At that time, we said in our report that we were encouraged by the attention being given to accounts receivable but that IRS actions did not appear to provide its CFO with the extensive involvement in revenue accounting called for in OMB's February 1991 guidance.

However, during our work in 1992, officials in the IRS CFO office said that the CFO has no authority over recording and reporting of tax receivables. Instead, the IRS Assistant Commissioner for Returns Processing is responsible for all aspects of IRS revenue accounting, including developing the data on receivables that IRS reports to Treasury and overseeing related system improvement efforts. The Assistant Commissioner does not report to the CFO but to the Chief Operations Officer, who is responsible for processing returns, recording assessments, and accounting for revenue.

Further, although an accounts receivable executive officer was appointed in May 1991, in October 1992, the position was moved from the CFO to the Chief Operations Officer. According to an internal IRS memorandum, this was done because some of the executive officer's responsibilities were closely related to the IRS "Compliance 2000" initiative, which focuses primarily on implementing changes in both the tax law and in IRS systems to facilitate taxpayer compliance. However, the accounts receivable executive officer's responsibilities, as outlined in the IRS June 1991 briefing to OMB, also include coordinating performance measures related to receivables and ensuring that IRS accounts for and reports receivables in accordance with generally accepted accounting principles. These are activities that are more appropriately the responsibility of the CFO, who is responsible for financial reporting.

Greater attention is now being focused on IRS financial reports due to the CFO Act's requirement that IRS develop annual financial statements beginning with fiscal year 1992, have them audited, and publish them in an annual report that also describes the agency's financial status and presents financial and programmatic performance indicators. As a result, it is more important than ever that IRS ensure the reliability of this information and its conformance with applicable standards. This is the type of responsibility that can be effectively discharged by a CFO who has the accounting expertise and the agencywide perspective needed and would be consistent with Treasury's and OMB's CFO guidance.

Also, regarding the development of new systems, a strong role for the CFO can help ensure that both internal and external accounting and reporting requirements are met. It is important that IRS accounting systems provide the data needed to support its financial reporting as well as enforcement actions and collection activities. This requires that accounting procedures and system designs be approved by the officials responsible for these tasks.

By overseeing the design of new and enhanced financial management systems, the CFO can help ensure that needed data are available. For example, the CFO Act requires that financial management systems produce cost information and provide for the systematic measurement of performance, and it places responsibility for designing performance measures with the CFO. If the CFO is to fulfill such responsibilities, the CFO must have the authority to review and approve new system designs.

Conclusions

A substantial portion of the IRS reported receivables balance will not yield revenue because it represents amounts that should never have been externally reported as receivables. IRS did not exclude these assessments from its receivables balance because its systems were designed primarily to support collection activities and other operating functions and were not designed to support financial reporting and other financial management functions. However, IRS' inability to provide reliable information on its receivables may mislead those who rely on these data, impair IRS collection efforts, and distort the IRS collection performance. IRS has improvement efforts under way that may reduce some erroneous assessments. However, they do not fully address IRS' need to distinguish between valid and invalid receivables, and they are not subject to approval by the IRS CFO, who is responsible for IRS financial statements.

Recommendations

We recommend that the Commissioner of the Internal Revenue Service provide the IRS Chief Financial Officer authority to ensure that IRS accounting system development efforts meet its financial reporting needs. At a minimum, the Chief Financial Officer's approval of related system designs should be required.

In addition, we recommend that the Commissioner direct the Chief Financial Officer to take steps to ensure the accuracy of the balances reported in IRS financial statements. In the long-term, this will require modifying IRS systems so that they are capable of (1) identifying which assessments currently recorded in the Master File System represent valid receivables and (2) designating new assessments that should be included in the receivables balance as they are recorded. Until these capabilities are implemented, IRS should rely on statistical sampling to determine what portion of its assessments represent valid receivables.

Further, we recommend that the Commissioner clearly designate the Chief Financial Officer as the official responsible for coordinating the development of performance measures related to receivables and for ensuring that IRS financial reports conform with applicable accounting standards.

Agency Comments and Our Evaluation

In its response, IRS supported our recommendations. Regarding our recommendation to provide the Chief Financial Officer authority to ensure that IRS accounting system development efforts meet its financial reporting needs, IRS stated that it is moving forward to place responsibility for the entire revenue accounting function under the Chief Financial Officer. As discussed in the report, we believe that this change will help ensure that IRS financial management systems support its financial reporting needs.

Regarding our recommendation that IRS ensure the accuracy of the receivable balance in its financial statements, IRS stated that it has made significant strides in evaluating its assessments and excluding certain assessments from its accounts receivable. Also, IRS said that it installed review processes designed to prevent erroneous assessments. As part of our ongoing financial audit of IRS, we plan to evaluate the effectiveness of these efforts.

Chapter 3

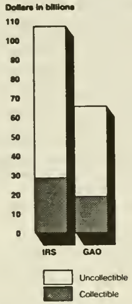
IRS Methodology for Estimating Collectibility Is Not Reliable

IRS estimates regarding the collectibility of its receivables were unreliable. Its June 1991 estimate did not involve any substantive analysis of collectibility, and the methodology used to develop its September estimate was flawed. In addition to including invalid receivables in this analysis, IRS (1) relied solely on collection experience associated with categories of assessments that were grouped according to their status in the collection process rather than their collection risk and (2) did not consider the taxpayers' current ability to pay. We estimate that $18.7 billion[1] of the estimated $65.3 billion in valid receivables was collectible as of June 30, 1991, while IRS estimated that $28.4 billion out of $107.0 billion was collectible as of September 30, 1991. Our analyses of the IRS reported gross receivables for the two dates showed that the size and composition were very similar. Accordingly, we believe that the $9.7 billion difference in estimated net receivables is largely attributable to the methodology used rather than to actual changes in the receivables' balance or collectibility.

Figure 3.1 compares IRS reported gross and net receivables as of September 30, 1991, with the results of our analysis of IRS June 30, 1991, receivables. Both analyses include only those receivables included in the IRS two largest receivables files—the IMF and BMF, which during fiscal year 1991 constituted 96 percent of IRS' gross receivables.

[1]The range of our confidence interval, at a 95 percent confidence level, is that the actual amount of collectible accounts receivable as of June 30, 1991, was between $13.7 billion and $23.1 billion.

Figure 3.1: Comparison of the IRS and GAO Estimates on the Collectibility of IRS Receivables as of September 1991 and June 1991, Respectively



Estimating Collectibility Requires Both Analysis of Individual Accounts and Groups and Consideration of Historic, Current, and Forecast Data

According to Title 2 of GAO's Policy and Procedures Manual for Guidance of Federal Agencies,[2] federal agencies are to estimate an allowance for uncollectible amounts based on past experience, present market conditions, and an analysis of the outstanding balances. In December 1992, the Federal Accounting Standards Advisory Board (FASAB) recommended "Accounting for Selected Assets and Liabilities," which provides more detailed criteria that federal agencies should apply when assessing the collectibility of their accounts receivable. FASAB's standard states that uncollectible amounts should be estimated based on an analysis of both individual accounts and groups of accounts and that historical, current, and forecast information regarding the debtors' ability to pay should be considered.

Regarding individual accounts, the new standard states that estimates should be based on (1) a debtor's current ability to pay, (2) the debtor's

[2]Federal accounting standards contained in Title 2 of GAO's Policy and Procedures Manual for Guidance of Federal Agencies are being examined by the Federal Accounting Standards Advisory Board. The Board, established in October 1990, is composed of 9 members, including representatives from GAO, OMB, and the Department of the Treasury. GAO and OMB may issue new standards based on the Board's recommendations. Like most federal agencies, the Department of the Treasury and IRS policies call for following the accounting standards prescribed by Title 2.

payment record and willingness to pay, and (3) the probable recovery of amounts from secondary sources, including liens, garnishments, and other applicable collection tools. For estimates made on a group basis, receivables should be separated into categories of homogeneous accounts with similar collection risk characteristics. Examples of characteristics to be considered include debtor type (individual or business), reasons that gave rise to the receivable, and geographic regions. Other factors that may be used to further stratify the groups are economic stability, payment history, alternative repayment sources, and age of receivables. The standard further states that, once groups have been established, sampling or modeling can be used to statistically estimate the collectibility of the receivables balance for each group. Statistical estimation should consider factors that are essential for estimating the level of losses, such as historical loss experience, recent economic events, and current and forecast economic conditions.

IRS Analysis Included Invalid Receivables and Did Not Consider Taxpayers' Current Ability to Pay

Prior to its September 30, 1991, report to Treasury, IRS did not have a meaningful methodology for estimating the uncollectible portion of its receivables balance. In its June 30, 1991, report to Treasury, IRS subtracted from its gross receivables $38.4 billion, which primarily represented assessments that it was not currently pursuing. However, this group of assessments, referred to as "currently not collectible," contained some assessments that were only temporarily suspended. In addition, this group was only one of 22 groups of assessments that IRS had established to monitor the status of assessments in the collection process. However, IRS did not assess the collectibility of and determine an allowance for the other 21 groups. For these reasons, its balance was not a reliable estimate of the collectibility of IRS receivables as a whole.

In its September 30, 1991, report to Treasury, IRS applied its newly adopted methodology for assessing the collectibility of its accounts receivable. Although this method involved a much more extensive analysis of IRS' receivables and represented a major effort by IRS to improve its analysis, it did not result in a reliable estimate of the uncollectible amount for the following reasons.

- IRS based its assessment on a significantly overstated gross receivables balance.
- IRS did not analyze any individual taxpayer accounts to determine the taxpayers' current ability to pay.

- Although IRS developed historical collection rates for groups of assessments, the assessments within these groups did not have similar collection risk characteristics, and IRS did not consider current and forecast economic conditions.

Overstated Gross Receivables Was an Inappropriate Starting Point

IRS included in its analysis all of its outstanding assessments. As discussed in chapter 2, this was not an appropriate starting point because it included assessments that did not represent valid receivables. In addition, IRS included amounts in its gross receivables balance that, although valid, would never be collected. For example, our sample included assessments against deceased taxpayers whose estates had no assets. This occurred because IRS reports all assessments regardless of their collectibility in its gross receivables balance until the statute of limitations for their collection, usually 10 years, expires. As a result, IRS continued to report some assessments for years after they had been determined uncollectible and continued to accrue related interest and penalties. Reporting such receivables, when they have no chance of being collected, compounds the difficulties in determining an appropriate allowance for uncollectible amounts.

Individual Accounts Not Examined

While standard practice has shown that an analysis of individual accounts is essential to estimate taxpayers' current ability to pay, IRS limited its analysis to groups of assessments. IRS' analysis did not consider individual taxpayers' current financial condition and future earning potential, including asset values and employment status; the age, amount, and number of past due accounts that an individual taxpayer had outstanding; payment history; or local economic conditions that might have a significant bearing on the collection of taxes. Such considerations are important if estimates of collectibility, which pertain only to a given point in time, are to reflect the most current economic conditions and ability of taxpayers to pay.

Assessing individual accounts is a challenge to IRS because its outstanding receivables include a large volume of low dollar assessments, as illustrated in chapter 1. However, statistical sampling is an efficient way to select a representative group of assessments to be reviewed in detail. Evaluating all items in the population over a given dollar value, while testing only a sample of items below this threshold can help ensure that a larger percentage of the value of a balance is reviewed.

Inappropriate Groups of Assessments Analyzed Solely on Historical Basis

The 22 categories of assessments that IRS analyzed were inappropriately grouped because they did not have similar collection risk characteristics. Instead, these categories, referred to as "program statuses," indicate what stage these assessments are currently going through in IRS' collection process. For example, IRS groups assessments into various notice stages that indicate whether a taxpayer has been sent a first notice, second notice, or third notice. IRS' largest program status is the category referred to as "currently not collectible."

IRS developed these "program statuses" to monitor and manage collection efforts, not to estimate or assess collectibility. As a result, the collection experience in any particular category may not be a good indicator of future collection rates for that category. For example, the "inactive program status" group includes assessments (1) in litigation, (2) involving bankruptcy, and (3) pending settlement—three distinct groups with varying collection risk characteristics. Grouping assessments into categories with similar collection risk characteristics, such as income level, certain types of taxes, or the source of the assessment, would allow IRS to develop historical experience and other information on homogeneous groups that would be a more reliable indication of each group's future payment performance.

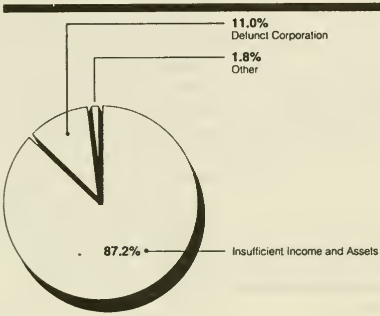
In addition, IRS considered only historical collection experience associated with the groups of assessments it analyzed. Current and forecast economic conditions were not considered. Although historical experience is an important factor, it probably will not accurately reflect future collection success when economic conditions change significantly.

Our Estimate Is Based on a Review of Individual Accounts

Our estimate that $18.7 billion in accounts receivable were collectible as of June 30, 1991, is based on our analysis of taxpayers' ability to pay the assessments in our sample. For each assessment, we considered all the information IRS had on each taxpayer's income, assets, debts, employment and economic status, payment history, and other outstanding assessments. Of the collectible receivables in our sample, at least 52 percent was currently payable. The remaining amounts were either (1) estate taxes which included deferred amounts or (2) assessments being paid in installments.

We estimate that $46.6 billion,[3] more than two-thirds of the $65.3 billion that we estimated to be valid receivables, were uncollectible. About 98 percent of the value of the uncollectible receivables in our sample was uncollectible because it was due from defunct corporations or from individuals or businesses that did not currently have sufficient income or assets to pay. Figure 3.2 shows the percentage of the value of the receivables in our sample that we determined were uncollectible for various reasons as of June 30, 1991.

Figure 3.2: Reasons Receivables in Our Sample Were Uncollectible (as a Percent of Dollar Values)



IRS' Collection Process Diminishes Accounts' Collectibility

Our estimate that less than one third of IRS' valid receivables are likely to be collected is a reflection, in part, of IRS' cumbersome collection process. In our December 1992 high risk report[4] on IRS receivables, we reported that the IRS collection process was lengthy, rigid, and inefficient. Typically, IRS begins its collection efforts with a series of written notices that are issued over a period of up to 6 months. If the delinquent assessment is not

[3]The range of our confidence interval, at a 95 percent confidence level, is that the actual amount of uncollectible accounts receivable as of June 30, 1991, was between $33.8 billion and $57.6 billion.

[4]Internal Revenue Service Receivables (GAO/HR-93-13, Dec. 1992).

resolved through the notice process, IRS attempts telephone contact and, if unsuccessful, uses more experienced collection employees to make face-to-face contact with taxpayers. However, this cumbersome process may diminish the ultimate collectibility of the receivable because of the length of time between when an assessment is made and the time IRS makes personal contact.

The lack of reliable data on IRS receivables has made the IRS cumbersome collection procedures even less effective. Because IRS cannot readily identify which accounts are valid or which have similar collection risk characteristics, it cannot be sure that it is allocating staff to the most fruitful accounts or that it is applying the most effective collection tools. In 1990, we testified before the Subcommittee on Oversight, House Committee on Ways and Means,[5] on our examination of the 98 largest IRS receivables accounts, which were valued at $6.2 billion. We found that during a 5 month period, IRS efforts had resulted in only $40 million in collections, while there were $2.7 billion in cancellations and adjustments resulting from erroneous assessments or misapplied payments. At that time, we said that better information on the value of its receivables would allow IRS to more effectively direct its collection efforts.

In addition, because IRS cannot determine what percentage of its valid receivables are collected, it cannot effectively evaluate its collection performance. Better information on its receivables should enable IRS to better measure its collection performance and better direct its collection efforts. The ability to link program decisions to financial results in this way is one goal of the CFO Act.

Conclusions

IRS has not developed a methodology for reliably estimating the amount of its receivables that is likely to be collected. In addition to impairing IRS' ability to reliably report its receivables in its financial statements, the lack of reliable information on collectibility of individual receivables diminishes IRS' ability to improve the effectiveness of its collection efforts and reliably measure its performance. FASAB has recommended standards for federal agencies to use that provide a more reliable basis for evaluating account collectibility. Following these standards would provide IRS with useful information on the collection risk associated with its receivables and allow it to more reliably estimate the collectible amount of its receivables balance.

[5] IRS Accounts Receivable Inventory (GAO/T-GGD-91-02, Oct. 18, 1990).

Recommendations

We recommend that the Commissioner of the Internal Revenue Service direct the Chief Financial Officer to modify the IRS methodology for assessing the collectibility of its receivables by

- including only valid accounts receivable in the analysis;
- eliminating, from the gross receivables balance, assessments determined to have no chance of being collected;
- including an analysis of individual taxpayer accounts to assess their ability to pay;
- basing group analyses on categories of assessments with similar collection risk characteristics; and
- considering current and forecast economic conditions, as well as historical collection data, in analyses of groups of assessments.

Once the appropriate data is accumulated, IRS may use modeling to analyze collectibility of accounts on a group basis, in addition to separately analyzing individual accounts. Such modeling should consider factors that are essential for estimating the level of losses, such as historical loss experience, recent economic events, and current and forecast economic conditions. In the meantime, statistical sampling should be used as the basis for both individual and group analyses.

Agency Comments and Our Evaluation

In its response, IRS agreed with our recommendations and stated that it will modify its methodology for determining the collectibility of receivables in line with our recommendations. In the interim, IRS said that it is conducting a statistical study of its accounts receivable. We plan to assess these efforts as part of our ongoing financial audit of IRS.

Appendix I

Comments From the Internal Revenue Service

Note: GAO comments supplementing those in the report text appear at the end of this appendix

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

MAR 1 5 1993

Mr. Donald H. Chapin
Assistant Comptroller General
Accounting and Financial Management Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Chapin,

Thank you for the opportunity to comment on the GAO draft report review entitled IRS' Reported Accounts Receivable Balance is Significantly Overstated. This draft is one of several we expect to receive as GAO continues its audit of our 1992 financial statements. I appreciate the efforts of your staff in addressing this issue, one that becomes increasingly important as the President and the Congress attempt to find ways to improve government and reduce the deficit.

See comment 1.

We support the recommendations contained in the report. As you know, in the full spirit of the Chief Financial Officers (CFO) Act of 1990, we had implemented one of your major recommendations to focus authority and responsibility for improved financial systems and financial reporting with our Chief Financial Officer. We are now moving forward to place responsibility for the entire revenue accounting function under the Chief Financial Officer.

Since the period covered by the report, we have made significant strides in evaluating our assessments and excluding certain assessments from accounts receivable. As an additional measure, we have installed review processes designed to prevent erroneous assessments from being made. We have also initiated two studies to reexamine the collection process.

See comment 2.

Another key recommendation is to modify our methodology for determining the collectibility of receivables. We believe our methodology is the appropriate starting point to measure collectibility and will modify it to bring it in line with the recently issued standards set forth by the Federal Accounting Standards Advisory Board. In the interim, we are pursuing your recommendation to conduct a statistical study on accounts receivable.

-2-

Mr. Donald H. Chapin

We recognize that with all our accomplishments there is still room to make improvements in financial management and reporting. We look forward to continuing our work with you in this effort.

We hope you find these comments useful.

Best regards.

Sincerely,

Michael P. Dolan
Acting Commissioner

The following are GAO's comments on the IRS letter dated March 15, 1993.

GAO Comments

1. The IRS response regarding the accuracy of its receivable balance and its CFO's responsibility is discussed in the "Agency Comments and Our Evaluation" section at the end of chapter 2.

2. The IRS response regarding its methodology for assessing the collectibility of its receivables is discussed in the "Agency Comments and Our Evaluation" section at the end of chapter 3.

Appendix II

Major Contributors to This Report

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Prepared Statement of Ms. Richardson

Introduction

Mr. Chairman and Distinguished Members of the Committee:

Good morning. I am pleased to be here with you today to discuss financial management at the Internal Revenue Service, the preparation and audit of financial statements as required by the Chief Financial Officers Act of 1990 (CFO Act), and actions we at the IRS are taking to ensure the successful implementation of the objectives of the CFO Act. With me are Michael P. Dolan, the Deputy Commissioner, and C. Morgan Kinghorn, the CFO designate.

I particularly welcome the opportunity to appear before you for the first time as Commissioner of Internal Revenue. I want to commend you, Mr. Chairman, for your sponsorship of the CFO Act. We at the IRS view this Act as a powerful management tool. The audit of our FY 1992 financial statements by the General Accounting Office provides a baseline by which we can measure improvements in the financial management of the IRS. That audit will be the keystone of our efforts to put the Service's financial management on sound footing to provide full accountability to the President, the Congress, and the American people.

Today's hearing focuses on the first set of CFO Act-related results in civilian agencies. For the IRS, it marks a major milestone—completion of our first financial statement audit—on the road to successfully implementing the spirit and letter of the CFO Act. I am pleased that the Act designated the IRS as one of the pilot agencies for the preparation and audit of financial statements.

I would like to address three issues today—financial management at the IRS, the General Accounting Office's audit of our FY 1992 financial statements, and our implementation of the CFO Act. Most importantly, I would like to give you a sense of the commitment we have made to implementing the full intent of the CFO Act with strong financial management leadership.

JOINT IRS/GAO GENERAL MANAGEMENT REVIEW PROVIDES A ROAD MAP FOR STRENGTHENING FINANCIAL MANAGEMENT AND ACCOUNTABILITY AT IRS

Efforts to improve financial management at the IRS did not suddenly start with the 1990 passage of the CFO Act. As the GAO correctly points out in its audit report, prior to 1989 there was no comprehensive effort devoted to improving financial management at the IRS. At that time, we were operating with outdated accounting systems that did not allow us to adequately account for the operations of our $6-billion-plus organization. We knew we had problems but did not know the extent of those problems. In 1988, after a two-year General Management Review which was an unprecedented joint effort between the IRS and the GAO, the GAO issued a report entitled "Managing IRS: Actions Needed to Assure Quality Service in the Future." One section of the report was devoted to improvements needed in financial management and included recommendations to establish a Chief Financial Officer, provide more focus to ensure the successful implementation of a new automated financial system, prepare financial statements and have them audited, develop a comprehensive cost accounting system, and include the IRS' problems in accounting for tax accounts receivable in the Federal Managers' Financial Integrity Act report. All of these recommendations have been adopted and implemented, however, the cost management system as I will explain later, has not been completed.

As the GAO also noted, we have made "important strides in addressing longstanding financial management problems" since the issuance of that General Management Review report. For example:

- Chief Financial Officer and Controller positions were established in the IRS in 1989 to provide financial management leadership.
- The Service hired a Controller with 20 years of financial management experience from outside of the IRS. That person, Morgan Kinghorn, has been designated as the new CFO.
- Starting in FY 1991, we added new expertise to the finance organization, thereby enhancing our accounting, budgeting and financial analysis capabilities in the process. We brought in experienced personnel, from inside and outside the IRS and outside government, to both the executive and analyst levels.
- Modern accounting software for our Automated Financial System was purchased and the system was: implemented in the Central Region and the National Office in FY 1992; and implemented servicewide at the beginning of FY 1993.

- A new payroll system was implemented in FY 1992. This system is fully integrated with the new automated financial system. Integration of the Service's financial systems is a major step in the direction of making financial information more accurate and timely.
- A cost management information system which is part of the Automated Financial System is being developed. It will integrate operational, financial and performance data. This system will provide decision support information on the cost of doing business to managers who must make decisions on how best to run their operations. The discipline of a cost management information system will force us to look at all our processes and assess each activity in the process as a value-added or non-value-added component of the process. In order to facilitate continuous business improvement, the IRS conducted a prototype analyzing the processing of individual tax returns in our Cincinnati Service Center in FY 1992. We continue to prototype additional processes in three districts and the Cincinnati Service Center. Full Servicewide implementation is scheduled for FY 1997.
- As you know, we are in the initial stages of the Tax Systems Modernization program, a program which affords us the opportunity to make major improvements in tax administration by reinventing the way the IRS does business. We believe the audit report highlights the necessity for implementing the Tax Systems Modernization program at the earliest possible time.

We believe we have made considerable progress in the past several years; however, most of our major efforts are not yet complete. Fiscal Year 1992 was a year of transition—working the bugs out of new systems, developing new procedures and coding structures, learning new systems and procedures, and training employees, while supporting a full financial audit. Fiscal Year 1993 will be much the same. Although, we still have a long way to go, I believe that we are headed in the right direction. I am certain you can appreciate that many of these solutions involve complex and long term actions. The General Management Review provided the springboard for our efforts. Now the CFO Act is providing our mandate for change. The IRS has made the commitment and is now making the required effort to improve its financial management processes and fully comply with the CFO Act.

GAO'S AUDIT OF FINANCIAL STATEMENTS PROVIDES A BASELINE FOR MEASURING IMPROVEMENTS IN FINANCIAL MANAGEMENT

We are discussing today the first audited financial statements ever prepared by the IRS. The General Accounting Office conducted the audit, and we worked closely with its staff during its eighteen month review of our operations. We viewed the audit as an opportunity to improve on our performance and accountability, and we truly appreciate the advice and counsel given us by the GAO staff. In order to maximize the benefits of the audit process, the GAO agreed to provide us with its findings as the audit progressed so that we could begin corrective actions on identified weaknesses. The GAO has not finalized all of its recommendations, but we are already working to implement thee that have been made. While there is still much the Service can and will improve on, GAO officials have stated that the IRS is moving in the right direction, and that they regard the IRS as a model for cooperation, openness, and willingness to address problems.

The impact of the GAO audit on the IRS has gone well beyond what the traditional accounting functional audit is supposed to address. While the IRS itself discovered and is dealing with many of these issues, it has caused us to review carefully the entire financial management of the IRS. The findings of the audit provide the baseline against which all changes in our financial management systems will be measured, and I can assure you that the many recommendations coming from this audit, both formal and informal, are being aggressively pursued throughout the IRS.

IRS HAS MOVED PROMPTLY TO ADDRESS GAO'S RECOMMENDATIONS DURING THE COURSE OF THIS AUDIT

The significant matters noted during the audit by the GAO relate to program areas of revenue, tax accounts receivable, and seized assets; and to administrative areas of property and equipment, management of operating funds, computer controls, and reports required by the Federal Managers' Financial Integrity Act.

Following is a summary of steps we have taken or we plan to take to address some of GAO's major findings.

Revenue

The GAO determined that the IRS' total reported revenues of about $1.1 trillion were collected and deposited into Treasury accounts. However, it also reported that it was unable to audit the various components of the total revenue collected, because the IRS' systems were not designed to provide the detailed information required to perform audit tests. The Tax System Modernization effort will be the long term solution to being able to provide the needed information. In the interim, however, we are addressing this concern by creating a computer program to pull all transaction data for FY 1993 from our Master File. As you can imagine, this is a tremendous task and represents billions of transaction records that will be transferred to the GAO for testing our reported balances. A test program is being run in August to ensure that it provides the detailed transaction information necessary to audit the balances reported on FY 1993 reports of revenue collected.

We also recognize that the current Federal Tax Deposit processing system does not provide us with the information needed to appropriately report on excise taxes collected. However, corrective action will require significant systemic changes. The Electronic Federal Tax Deposit system may offer one solution by providing an option to capture both accounting and payment information at the time a payment is made.

Tax Accounts Receivable

During the course of the audit, the GAO used a sample to look at our accounts receivable balance. Its test indicated that our accounts receivable balance was significantly overstated. We adopted the methodology proposed by the GAO, and we used a statistically valid sample to determine accounts receivable for financial reporting purposes. From the sample data, we adjusted our reported accounts receivable balance downward to a figure we mutually agree is a better reflection of what is collectible. We also are working on long term solutions to this problem to find ways to more accurately report the IRS' accounts receivable for financial reporting purposes, and we believe we have made progress. We have removed duplicate and uncollectible assessments that tended to overstate the total receivables, and we have installed review procedures to prevent erroneous assessments due to the IRS or taxpayer error from becoming part of our accounts receivable balance.

Seized Assets

The reconciliation of our records of assets seized by our Criminal Investigation function has been completed; and the reconciliation of our records of assets seized by the Collection function is almost complete. Also, to more effectively manage and dispose of seized assets, we have contracted with a private vendor to provide management services for assets seized by our Criminal Investigation function. Although inventory information is to be provided by the vendor, as a control measure we will continue to maintain current and accurate information on seized assets held by the vendor.

The Collection function is implementing an inventory software program to provide the information necessary to manage assets seized by revenue officers. The software is to be piloted by the end of September of this year.

Automated Data Processing Property and Equipment

In order to ensure accountability over property and equipment, we have taken several actions which will be completed this year. We are nearing completion of a total physical inventory of automated data processing equipment and reconciling the cost of this equipment with acquisition documents. We will perform reviews at selected sites to validate the accuracy of the inventory data, and are finalizing operating procedures to strengthen guidance on maintaining the accuracy of inventory records.

Management of Operating Funds

We recognized the deficiencies in our administrative accounting systems several years ago. In order to address them and provide management with the information needed to make informed decisions, we installed software for a fully integrated accounting/budgeting system in 1991 and implemented it Servicewide at the beginning of FY 1993. The system will provide the data necessary to prepare accurate financial statements and the controls necessary to effectively manage spending to ensure compliance with Congressional mandates regarding the use of appropriated funds.

Computer

Commuter Controls

During the course of the audit, GAO referenced work done by our own Internal Audit staff on the security of our Integrated Data Retrieval System (IDRS). IDRS is the largest data base of taxpayer accounts accessed by IRS employees for the performance of their duties. IDRS has approximately 56,000 authorized users nationwide, processing in excess of 100 million transactions a month. This system, while over 20 years old, has virtually all of the security features required by the National Institute of Standards and Technology for systems that process sensitive information.

- All users are assigned both a User Identification Number and a password.
- The employee identification number includes specific data identifying the individual user including location, division, branch, and organization.
- Passwords are used in addition to the identification number and authorized users are profiled for access to only certain command codes based on the type of work being performed.
- In addition, each IDRS terminal has unique identification so that the audit trail for every transaction not only identifies the individual but the specific terminal used.
- System access requires management review and approval, including performance of a background investigation.
- All new IDRS users are given IDRS security training.

Mr. Chairman, the IRS has always had strong policies and procedures in place to allow only authorized employees to access taxpayer accounts and have taken disciplinary action where abuses were found. As a result of our own internal reviews, we have taken steps to put greater management emphasis to ensure that the privacy and security of taxpayer information is safeguarded. Ethics is one of the Service's five major business strategies. Embedded in our ethics training, which is mandatory for all IRS employees, is the necessity to protect the privacy of taxpayer data. Specific scenarios related to IDRS security are included in the Service Center training materials.

While the financial audit brought attention to the area of IDRS security, the IRS took the initiative in 1989 to bring to bear the efficiency of automation in monitoring employee access of IDRS. Only because our IDRS security system data base provided the audit trail information was Internal Audit able to perform several extensive reviews of IDRS resulting in the detection of inappropriate use of the computer system by a few of our employees. The growth of the user base since the introduction of IDRS has resulted in transaction volumes that mean we must build new systemic ways to monitor activity that takes place in our computer systems. Many new security features are being incorporated in our Tax Systems Modernization design efforts. But in the interim, we have initiated an effort to enhance our ability to review the IDRS audit trails utilizing new technology. The new technology will allow for computer assisted analysis and tracking of transactions and facilitates the identification of inappropriate trends of activity and access. This capability will allow our security analyst staffs to monitor all activity thoroughly and to detect inappropriate use. This technology is currently being piloted in the Southeast Region, and we expect that the remaining regions will be fully implemented by early 1994.

Federal Managers' Financial Integrity Act

The IRS is reorganizing its internal control oversight programs, including those required by the Federal Managers' Financial Integrity Act, by consolidating dispersed staffs into one office under the CFO. Last December, we established a Senior Council for Management Control chaired by the Deputy Commissioner, with the Chief Financial Officer as deputy chair. The membership of this group also includes the Chief Operating Officer, the Chief Information Officer, and the Chief Inspector. This group meets quarterly with various senior executives to review the status of internal control programs and to ensure that our assurance process is strengthened by emphasizing improved review procedures and validating that corrective actions taken have worked.

IRS VIEWS THE CFO ACT AS A MANDATE FOR CHANGE

We at the Internal Revenue Service are not only committed to implementing provisions of the CFO Act we have also made a commitment to ourselves, and will make it to this Committee, to serve as a model for financial management improvement for the entire Federal Government. The Act and the audit it requires have allowed us to see the totality of financial management concerns confronting us. Reports from Internal Audit, the General Accounting Office, the Inspector General, and the Federal Managers' Financial Integrity Act are each helpful in their own way, but none of these bring together all the findings and corrective actions in a comprehensive manner. The process of preparing and auditing financial statements under the CFO Act has given us the "big picture" for the first time—and this will enable us to better plan solutions and manage their implementation.

Fiscal Year 1992 was a year of unprecedented challenge for financial management at the Internal Revenue Service. We implemented a new automated financial system and completed converting to a new payroll system. We began developing a cost management system that, by FY 1997, will provide managers with information on the costs of doing business, the value added by their work processes, and the results of their actions. We also developed key performance indicators for our programs which reflect the results of our operations, and place us in the forefront of performance measurement in the Federal Government.

In designing and preparing our FY 1992 financial statements, we established an open working relationship with our counterparts at Treasury, Office of Management and Budget and the General Accounting Office. We discussed our progress with these organizations, asked for advice and input, and received feedback that has been incorporated in the final product. With the GAO'sadvice and assistance, we have identified several significant issues and improvements that are needed, and we have begun to address them. This relationship has greatly improved communications with these groups and fostered better understanding and support for our programs and objectives.

Finally, we have begun to change the corporate culture—one which traditionally, like much of the Federal Government, did not emphasize financial management. We are now looking at our accounts receivable as a Federal corporate asset, not as just an IRS program function, and in response to GAO's suggestion, we have already changed the way it is reported. We have begun decentralizing our operating budget to our field offices, a process which permits our field managers to make financial decisions and holds them accountable for their management of resources. We are developing and implementing automated systems that will put more timely and accurate financial information in the hands of managers. With the progress we have made so far, there is a heightened awareness of financial management implications throughout the organization, a recognition of financial accountability in non-financial areas, and the integration of fiscal considerations in program decisions.

CONTINUED IMPROVEMENTS IN FINANCIAL MANAGEMENT ARE PLANNED TO ENSURE SUCCESSFUL ACCOMPLISHMENT OF CFO ACT OBJECTIVES

As you can see, Mr. Chairman, we are serious about identifying the weaknesses in our financial management systems and equally serious about correcting them. We have taken action in many areas, both in tax administration and in the management of operating funds, that will address these weaknesses and ensure much better audit results in the years to come. But this is not the real solution to fulfilling the spirit of the CFO Act, nor to upholding our commitment to serve as a model for financial management improvement throughout the Federal Government—there must also be a corporate commitment to continued improvement. We also have specific plans to help ensure that the progress we have made continues:

- First and foremost, based on our experience with the recent GAO audit, we believe that all government agencies should prepare annual financial statements and have them audited. Our experience has been that the benefits of systematically identifying problems and measuring progress are truly significant. In addition, as I have stated earlier, the real value of the financial statements is the comprehensive view they provide of the financial management issues that confront the IRS in effectively and efficiently running our operations.
- We began a major reorganization of the Service that will, among other things, consolidate financial management programs and systems under the CFO. Responsibility for overseeing revenue accounting and reporting, accounts receivable, monitoring internal controls, and follow up on financial audit corrective actions is being consolidated under the CFO.
- The full implementation of the cost management system will provide component costs of IRS' operations to help managers make better informed financial management decisions. It will also help managers make better informed program decisions by letting them know the costs, the value added, and the outcomes of those decisions. This system will give IRS a head start in implementing many of the provisions of S. 20.
- To better manage our operating funds, we are looking at various options for streamlining our payment operations. In FY 1994 we are opening an offsite pay-

ment center that will initially process all payments related to the Tax Systems Modernization initiatives. This may expand into a centralized payment center for other components of the Service in the future.

- Finally, we are redesigning our revenue accounting and reporting system to ensure that the information we provide to the President, the Congress, and the American taxpayer is more consistent with the financial statement reporting requirements of the Act.

Mr. Chairman, these are ambitious plans but I have been assured they are not unreasonable ones. With the continued support of this Committee, the Department of the Treasury, the Comptroller General, and the Administration, I believe that the impetus provided by the CFO Act can be successfully extended and expanded.

Mr. Chairman, that concludes my remarks. My colleagues and I would be happy to answer any questions.

REVIEW OF CONTROLS OVER IDRS SECURITY IN THE SOUTHEAST REGION

DIGEST

This report presents the results of our Regional Audit of controls over the Integrated Data Retrieval System (IDRS) and a summary of actions taken by the Regional Commissioner to immediately address management and integrity issues at the regional level as the review progressed. The review began as an Inspection Integrity Project based on an extensive analysis of the IDRS audit trail. We initiated the review of controls over IDRS security after indications of misuse of IDRS were identified in each office in the region. A separate National Audit is in process to develop and report the national implications of the control weaknesses identified during this review.

For almost 20 years, the IDRS has been the primary computer system for accessing and adjusting taxpayer accounts. In the early 1970's, the taxpayer accounts on IDRS were limited primarily to delinquent or notice accounts. There were fewer users on the system and adjustment authority was highly restricted. To enhance taxpayer service, IDRS has evolved into a system that provides employees with almost immediate access to taxpayer accounts; however, the IDRS security system has not kept pace with significant changes in user capabilities.

Our review of IDRS controls identified three areas that need management attention:

- Controls do not adequately monitor employee actions taken on the system. Our tests showed that the available security reports and programs are often not effective in helping security personnel identify potential employee misuse of IDRS.

- Disciplinary actions taken against employees who violate IDRS security rules are not consistent. Repeat violations of the IDRS security rules do not always result in increased severity of the disciplinary actions.

- The IDRS security program does not have the managerial emphasis needed to ensure its effectiveness. Management often delegates IDRS security duties to technical employees who are consumed with other tasks. The employees, who are security representatives, spend a limited amount of time reviewing the IDRS activities of an increasing number of users.

Our computer analysis was limited to one command code, "REINF," which is assigned to approximately 6,300 Southeast Region IDRS users. The command code is used to assist Internal Revenue Service employees in determining if a tax return has been processed and the amount and date of the refund. The REINF command code is considered a "research" command code because employees cannot use it to change taxpayer accounts. REINF was used about two million times during 1989 and 1990 in the Southeast Region.

Our analysis of REINF usage found strong indicators that 368 employees monitored non-work related accounts, including those of friends, relatives, associates, neighbors, or celebrities. Of the 368 employees, 289 were referred to their respective heads of office for administrative follow-up and any appropriate disciplinary action. The other 79 employees were referred to Internal Security for evaluation and investigation of potential criminal violations by the employees. To date, the investigations have established that four employees prepared fraudulent returns for taxpayers and then monitored the accounts on IDRS. The actions of these four employees are being reviewed by the appropriate U.S. Attorney for potential criminal prosecution. Of the four employees, one resigned from the Service prior to the investigation, one was removed from the Service, one was suspended and one has been reassigned to other duties pending completion of the investigation.

Taxpayer confidence in the Service's ability to ensure the privacy of tax data is diminished when situations such as those above are identified. Also, employees are unproductive and may be violating disclosure laws when official information is obtained and used for non-business reasons.

The Regional Commissioner took immediate action to address improvements in IDRS controls, consistent disciplinary actions, and the management emphasis given to IDRS. Articles about IDRS security were published in District and Service Center newsletters and IDRS security was included on two editions of the southeast video magazine "Insight". Also, a task force consisting of personnel from the Data Processing and Resources Management areas was established to work closely with the Regional Inspector's office to identify system abuse and ways to strengthen IDRS security. The Regional Commissioner has personally emphasized IDRS security to the District and Service Center Directors and has provided guidance in addressing problems which could be improved by the region.

In addition, IDRS security was included in the regional annual business plan and all IDRS users have gone through a recertification process which explained the users' responsibilities when using IDRS. Also, all managers who supervise IDRS users will be trained regarding their responsibilities concerning IDRS security.

The complete draft of the revised RC-SE Memorandum and the memorandums from the Regional Commissioner and the Assistant Regional Commissioners (Data Processing and Resources Management) to all District and Service Center Directors are included as Attachments III, IV and V of this report.

REVIEW OF CONTROLS OVER IDRS SECURITY IN THE SOUTHEAST REGION

INTRODUCTION

This report presents the results of our Regional Audit of controls over the Integrated Data Retrieval System (IDRS); the results of an extensive computer analysis of employee use of one IDRS research command code over an approximate two year period; and a summary of actions taken by the Regional Commissioner to immediately address management and security issues at the regional level as the review progressed. A separate National Audit was also initiated to develop and report the national implications of the control weaknesses identified during this review.

The review began as an Inspection integrity project based on an extensive analysis of the IDRS audit trail. We initiated the Regional and National Audits after extensive computer analyses identified misuse of IDRS in each office in the region. Further tests showed that security and management controls were not sufficient to detect and deter repetitive employee accesses to taxpayer accounts in cases where there were no clear business reasons for the accesses. Most of the non-business accesses by employees appeared to be administrative violations of Service rules and guidelines. However, in a significant number of cases, the data indicated that employees may be involved in criminal conspiracies with others to defraud the government, generally through the filing of tax returns claiming inflated refunds.

We conducted the review in accordance with generally accepted government auditing standards. We performed on-site interviews and tests in the Regional Office, Atlanta Service Center (ATSC) and Atlanta District. We conducted the computer analyses of employee use of one IDRS research command code in each of the district and service center offices in the Southeast Region.

BACKGROUND

The Internal Revenue Service (IRS) has become increasingly dependent on automated information systems to accomplish its mission. Each IRS service center maintains a database system, commonly called the IDRS. This system contains sensitive tax information about taxpayers serviced by the respective center. Authorized IDRS users access information through terminals located throughout the service center, regional, and district offices. In the Southeast Region, 265 security representatives are responsible for monitoring the IDRS activities for approximately 10,000 users.

The key to accessing information on IDRS is the taxpayer Social Security Number (SSN). The SSN is used with a command code which tells the computer the action to take. The two major categories of command codes are research and sensitive. Research command codes are used to query account information on IDRS such as determining when a refund will be issued. Sensitive command codes are used to change account information such as making adjustments and transferring credits from one account to another.

The IDRS security controls were instituted in the early 1970's. At that time, IDRS had limits to information that do not exist in 1992. For example, in the early 1970's, the accounts on IDRS were limited to primarily delinquent or notice accounts. Also, there were fewer terminals and fewer employees with IDRS capabilities in District offices, and adjustment authority was highly restricted and generally limited to groups of Service Center employees.

District employees now have adjustment capabilities. Also, Service Tax System Modernization efforts through such initiatives as Corporate Files On Line (CFOL), have expanded the information employees can access on IDRS. For example, before CFOL, employees only had access to accounts serviced by a particular service center. However, CFOL allows employees to obtain nationwide entity and tax return information. This greatly increases the risk of employee browsing, disclosure or fraud.

OBJECTIVES AND SCOPE OF REVIEW

Our objectives were to: (1) identify trends of potential improprieties involving employees using IDRS; (2) determine how the IDRS security system could more effectively detect disclosure violations or fraud; and, (3) determine if organizational emphasis placed on IDRS security is consistent with the many legal and ethical requirements to protect taxpayer information. The detailed objectives and scope of review are included in Attachment I to the report.

Our review originated as an extensive computer analysis of the research command code REINF. This command code is used to determine if a taxpayer's tax return posted to the master file. REINF also shows the amount and date of release for any refund due the taxpayer. This command code was utilized about two million times in 1989 and 1990 by approximately 6,300 Southeast Region employees. REINF is only one of many research command codes and other sensitive command codes that are available for use by employees.

RESULTS OF REVIEW

Our review showed that controls do not adequately monitor actions taken on the system by employees. Our tests showed that there is a wide disparity of disciplinary actions taken against employees who violate IDRS security rules. We also found a lack of emphasis placed on the IDRS security program. We discuss these areas below.

CONTROLS OVER THE IDRS SECURITY SYSTEM DO NOT EFFECTIVELY DETECT EMPLOYEE MISUSE OF THE SYSTEM AND PROTECT TAXPAYER INFORMATION

Public Law, Treasury Directives and Internal Revenue Manual guidelines require the IRS to protect the integrity, availability and privacy of taxpayer information on its systems. Each office has security personnel who are responsible for monitoring all IDRS activities; however, the number of full time personnel is limited.

The IDRS security officer has overall responsibility for monitoring the IDRS security program in the service centers and districts. However, the duties performed generally consist of distributing security reports to the unit security representatives and assigning profiles for users.

Unit security representatives also monitor the IDRS security program and are responsible for all security matters within their unit. However, IDRS security is a collateral duty and generally, written expectations are not given to the security representatives. Also, none of the 33 security representatives we interviewed had ever detected employees misusing IDRS.

The tools provided to security personnel are not effective in helping them identify potential employee misuse of the IDRS. The current tools available include security reports which identify employees who access their own, their spouse's or other employee's accounts. Other reports show command code usage and ratios for employees signing on and off the system. These reports do not assist security personnel in identifying potential browsing, disclosure or other integrity problems. Other tools provided to security personnel are a daily audit trail of accesses to IDRS and a utility program which can be used to search the audit trail. However, neither of these tools can be used efficiently to identify trends of IDRS misuse over a period of time.

Ineffective security controls over IDRS allowed employee fraud to occur. We reviewed the IDRS audit trail for all or portions of calendar years 1989, 1990, and 1991 in 12 offices within the Southeast Region. The review showed that 1,118 employees used command code REINF to access the same taxpayer's account on three or more days or during more than one calendar year. We developed a computer program to analyze various master file data to produce reports for each employee and the taxpayers they accessed. The reports showed among other things, entity information about each employee and the taxpayer they accessed, the frequency of REINF accesses by the employee, filing status history, tax return characteristics, multiple refunds, and the ratio of Schedule A deductions to adjusted gross income. The following are examples of techniques used to identify the most suspect cases:

- compared employee entity information (i.e. name and address) with that of the accessed taxpayer;

- compared filing status history and tax return history (i.e. type of return, filing status, credits taken) for unusual trends:

- reviewed employee personnel files to obtain handwriting samples and to determine if the accessed taxpayers were relatives, friends, etc.;

- compared the handwriting in the personnel files to the handwriting on original returns prepared by the employee; and,

- matched the accounts accessed to inventory files such as the Delinquent Inventory Account Listing (DIAL) and Problem Resolution Management Information System (PROMIS) to determine if employees were actively working the accounts.

Through the above techniques, we determined that the activity of 750 employees did not warrant additional action. Generally, taxpayers accessed by these employees had conditions that could require employees to access the accounts.

Of the remaining 368 employees, 79 were referred to Internal Security for further investigation of potential refund schemes. The United States Attorney is evaluating the actions of four employees for criminal prosecution. In one case, an employee prepared over 200 fraudulent tax returns and monitored the refunds on IDRS using REINF. One hundred ninety taxpayer returns were referred to the Examination Division for audit. To date, assessments total $310,564 in tax, interest, penalties and earned income credit reversals. The remaining tax returns are included in the criminal prosecution case that the U.S. Attorney is evaluating.

In two other cases, our analysis showed that the employees used REINF to access accounts of taxpayers who lived in the same area as the employee. Both employees prepared fraudulent returns for an undercover Inspector and accepted payment for doing so. In the remaining case, the employee used her position to input fraudulent adjustments and monitor the accounts of local taxpayers. She also prepared fraudulent returns, including returns for herself and her parents.

There were also indications that 289 employees monitored the accounts of friends, relatives, associates or neighbors on IDRS for no clear business reason. The schedule below shows the number of employees by office.

Schedule of Results By Office

Office	Employees Reviewed	Employees Resolved	Referrals To I.S.	Referrals To Mgmt
MSC	45	33	7	5
ATSC	246	221	2	23
Atlanta	178	147	4	27
Greensboro	106	52	6	48
Jacksonville	140	68	11	61
Birmingham	59	20	4	35
Little Rock	34	13	3	18
Nashville	112	66	3	43
Columbia	49	37	12	0
Ft. Lauderdale	62	52	8	2
New Orleans	55	28	11	16
Jackson	32	13	8	11
Totals	1,118	750	79	289

We referred these employees to their respective heads of office through the Regional Commissioner for appropriate administrative follow-up and disciplinary actions where appropriate.

Corrective Actions Taken

The Regional Commissioner formed a task force consisting of personnel from the Resources Management and Data Processing areas to work closely with the Regional Inspector's office to identify system abuse and ways to strengthen IDRS security. The task force conducted a workshop for all Service Center and District security officers to define the roles and responsibilities of security personnel and to explore ways to more effectively review the security reports. The workshop also addressed the use of different types of audit trail extracts to identify IDRS misuse. The Regional Commissioner also issued a memorandum to all District and Service Center Directors that provided guidance for the control and disposition of the 289 administrative cases.

In addition, IDRS security was included in the regional annual business plan and all users have gone through a recertification process which explained the users' responsibilities when using IDRS. All managers who supervise IDRS users will be trained regarding responsibilities concerning IDRS security.

CONSISTENT DISCIPLINARY ACTIONS ARE NOT TAKEN AGAINST EMPLOYEES WHO VIOLATE IDRS SECURITY RULES

We reviewed records maintained by Labor Relations for a three year period for the Atlanta District and the Atlanta Service Center. Our analysis showed that 154 employees accessed their own accounts or the accounts of celebrities, friends, or relatives for no clear business purpose. The disciplinary actions taken were inconsistent for the same type of violation. For example, one employee accessed their own account and no action was taken while another employee was reprimanded for accessing their own account. (See Attachment II for details).

Some offenses, in and of themselves, may not be serious enough to warrant removal to correct the conduct of the employee. In such cases, the least severe corrective action which achieves the desired result should be used. If the disciplinary action taken does not achieve the desired results, then more severe disciplinary action is warranted for repetition of the unacceptable conduct. Progressive discipline is warranted when the lesser disciplinary action did not correct the conduct of the employee. This concept of progressive discipline should be used by management as warranted.

Our review showed that progressive discipline was not always used by management. We identified ten employees who repeatedly violated IDRS security rules. However, the severity of the disciplinary action for six of the ten employees either decreased to a lesser action or remained the same as the prior action taken.

The Service has not established specific guidelines to ensure that the disciplinary actions imposed are consistent. Guidelines state that disciplinary actions can be taken when employees violate security rules. The rules state that employees should not access taxpayer accounts for other than official reasons. Accessing your own account for any reason is prohibited. The disciplinary action given must be fair, equitable, as timely as possible and consistent.

Adherence to IDRS security rules diminishes when disciplinary actions administered to employees are inconsistent. Inconsistent disciplinary actions also result in inequitable treatment of employees and give the appearance that IDRS security violations are not a serious matter.

Corrective Actions Taken

The Regional Commissioner formed a task force consisting of personnel from Regional Labor Relations to address this area. The task force prepared guidelines for determining the appropriate actions to take when IDRS security violations occur. Additionally, RC-SE 1(16)22 was revised to provide guidelines on who to notify when suspected improper accesses are discovered. (Attachment III)

THE IDRS SECURITY PROGRAM HAS NOT RECEIVED APPROPRIATE EMPHASIS BY MANAGEMENT

Management is responsible for the overall security of IDRS. However, the responsibility is often delegated to technical employees who are consumed with other duties. The security representatives spend a limited amount of time reviewing the IDRS activities of an increasing number of users. When IDRS security reviews conflict with other work related assignments, the work related assignments take priority over the security reviews.

Most security representatives are not given formal expectations for IDRS security and their IDRS security duties are generally not evaluated. Security representatives are inconsistently trained and are not given instruction on how to detect employee misuse of the system. In most cases, the security representatives interviewed were determining whether employees sign on and off the system as required.

Standards for internal control in the federal government require that internal control systems are established and maintained to ensure that all assets are safeguarded against unauthorized use and misappropriation. In order to accomplish this, managers and their employees should maintain and demonstrate the skills necessary to ensure effective performance of their responsibilities. Also, employees should be given the necessary formal and on-the-job training.

During the past year, less than 37 percent of the total staff years budgeted for the security program at the ATSC and the Atlanta District were specifically used for IDRS. During this time, initiatives such as preventing computer viruses on mini and micro computer systems took precedence over IDRS in the allocation of security resources.

This allocation of security resources may be quite appropriate based on the perceived risks of the mini and micro computers. However, the opportunity for improprieties and administrative violations to occur and go undetected is enhanced when appropriate attention is not provided over the security of the IDRS.

Corrective Actions Taken

The Regional Commissioner personally emphasized IDRS security in the revised RC-SE Memorandum 1(16)22. The memorandum was also revised to outline specific responsibilities for the District and Service Center security officer and security representatives. The memorandum also required all security representatives to have non-bargaining unit status due to their access to information sensitive in nature. In addition, management will evaluate the effectiveness of the IDRS security program and ensure that the position descriptions of the IDRS security representatives accurately reflect IDRS security responsibilities.

The complete draft of the revised RC-SE Memorandum and the memorandum from the Regional Commissioner to all Service Center and District Directors are included as Attachments III and IV of the report.

Thomas H Black

Thomas H. Black
Audit Manager

ATTACHMENT I

DETAILED OBJECTIVES AND SCOPE OF REVIEW

Our objectives were to identify employee integrity issues regarding tax return preparation and abuse of IDRS; determine how the IDRS security system could more effectively detect disclosure violations or fraud; and determine whether the organizational emphasis placed on IDRS security is consistent with the many legal and ethical requirements. To accomplish our objectives, we performed the following tests.

I. To identify employee integrity issues regarding tax return preparation and abuse of IDRS, we initiated four coordinated integrity projects in the region, and we:

A. obtained IDRS audit trail for all or portions of the period January 1989 through May 1991 for all SER IDRS users who used command code REINF;

B. used locally developed computer programs to analyze IDRS audit trail for trends. This resulted in identifying the most frequent and continual users of command code REINF. For example, we identified employees who accessed the same taxpayer accounts year after year for no clear business purpose. We paid close attention to taxpayers who lived near the employees;

C. judgmentally selected taxpayers where there was the appearance of IDRS activity of a non-business nature by the employee. This judgment was influenced by indicators from computer analysis results in step "B". Review procedures for selected cases included some or all of the following:

- reviewed available Internal Security information about the employees;
- reviewed employee personnel file documents for indications of a relationship with taxpayers they accessed;
- compared employee handwriting (from existing documents) to handwriting on taxpayer tax returns for one or more years;
- reviewed employee and taxpayer returns for questionable exemptions, deductions, credits, etc.; and,
- reviewed master file transcripts and supporting documentation for adjustments to taxpayers' accounts; and,

D. referred any strong indicators of wrong doing to Internal Security or management, where appropriate. Also, we referred certain questionable tax returns to the appropriate examination function for audit.

II. To determine how the security system over IDRS could be more effective in detecting or preventing improprieties from occurring, we:

A. obtained and reviewed criteria defining data security for government and business;

B. determined how the regional and local offices assure that IDRS security is protected by:

- interviewing security personnel and managers and reviewing procedures and guidelines for IDRS security, security officers, and security representatives;

- reviewing read files from the District Information Systems Division and regional office Data Processing section;

C. obtained and reviewed prior GAO, Internal Audit, regional, and local reports and findings on IDRS;

D. determined whether quality improvement projects or systems analysis projects were conducted to identify and correct problems with the existing IDRS security system;

E. determined if the security reports were effective in helping security personnel identify unauthorized accesses by:

- identifying and analyzing security reports available for use by security personnel;

- comparing listings of ATSC employees who accessed taxpayer accounts for non-work related purposes to the Manager's Weekly Security Reports to determine if the reports showed the accesses;

F. interviewed the current and one former ATSC security officer, and 33 security representatives from ATSC, Atlanta, Columbia and New Orleans Districts to:

- determine how they use the security reports;

- determine if security personnel had recommendations to make the IDRS security system more effective;

- evaluate the adequacy and consistency of training provided to the security officers and representatives; and,

G. interviewed the ATSC security officer and 22 ATSC and Atlanta District security representatives and researched the IRM to evaluate security personnel procedures for distributing, reviewing, and disposing of security reports;

H. determined how consistently and fairly security violations are dealt with by:

- determining whether standards exist for deciding appropriate disciplinary actions;

- obtaining and reviewing cases from August 1987 through August 1990 from ATSC and Atlanta District Labor Relations files;

- comparing a list of 20 ATSC and Atlanta District employees who accessed their own, spouse's, or other employee accounts for non-work related purposes, to files in Labor Relations to determine whether the employees received disciplinary actions for their security violations (the list was obtained from the REINF project);

I. met with Internal Security to solicit ideas or suggestions on ways to detect or prevent improprieties from occurring through the misuse of IDRS; and,

J. obtained and analyzed criminal violations involving the use of IDRS over the last three years, from Internal Security.

III. To determine if the funding and organizational emphasis devoted to IDRS data security is consistent with the many legal and ethical requirements to protect taxpayer information we:

A. reviewed the Strategic Business Plan and regional and local Annual Business Plans for the various functional areas within the Service for FY 1990 and 1991 to determine if the plans clearly direct management toward assuring a secure IDRS system;

B. interviewed ATSC and Atlanta District division and branch chiefs to determine if top management's expectations of the security representatives are consistent with the actual duties performed;

C. reviewed the position descriptions, evaluations, and expectations for the former ATSC security officer and 22 ATSC and Atlanta District security representatives to determine:

- whether expectations and performance standards were effectively communicated to the security representatives;

- whether their position descriptions and job elements include security duties; and,

- whether they were evaluated on their security duties and to evaluate the effectiveness of the evaluations conducted;

D. obtained and analyzed budget information to determine whether the funds budgeted for security were utilized for IDRS security by the region, districts, and service centers;

E. interviewed the current and former regional security analysts and two former ATSC security officers to:

- determine whether the effectiveness of the security officer was studied or enhanced over the last 20 years;

- determine whether regional and local offices conducted oversight reviews; and,

- determine whether the training program for security personnel emphasizes how to detect improprieties.

ATTACHMENT II

DISCIPLINARY ACTIONS TAKEN ON
ATSC AND ATLANTA DISTRICT EMPLOYEES[1]
FROM 8/01/87 - 8/31/90

	OWN	EMPLOYEE	RELATIVE/ FRIEND	CELEBRITY	TOTALS
NO ACTION	16	4	1	1	22
COUNSELLED	62	22	3	1	88
ADMONISHMENT	12	5	6		23
REPRIMAND	7	4	6	1	18
3-DAY SUSPENSION			2		2
30-DAY SUSPENSION			1		1
TOTALS	97	35	19	3	154

[1]These statistics were taken from our review of Labor Relations files. Without interviewing specific individuals, it is not possible to determine if there were mitigating circumstances which were not documented in Labor Relations files.

A. PURPOSE

This Memorandum supplements the IDRS Security Handbook and establishes IDRS data security responsibilities within the Southeast Region. IDRS administrative duties are being enhanced to establish a closer working relationship among the District Office and Service Center IDRS Security Officers, IRS management and the IRS Inspection Service to detect any instance of system abuse.

B. SCOPE

The provisions of this Memorandum apply to all offices utilizing IDRS in the Southeast Region including all offices of Regional Appeals and Regional Inspection.

C. DEFINITIONS

See Attachment 1 for a list of definitions used throughout this document.

D. DESIGNATION OF SECURITY PERSONNEL

1. Service Center and Regional Inspection Organization

   a. An IDRS Security Officer and the alternate(s) will be designated by each center and will be located in the Security Function of the Information Systems and Accounting Division.

   b. An IDRS security representative and alternate shall be designated for each IDRS unit. The representative may be responsible for more than one unit. A current list of designated representatives will be maintained by the service center IDRS Security Officer.

   c. The designated IDRS security representatives must be non-bargaining unit employees due to the sensitive nature of the information contained on the IDRS security reports and the management decisions that will be required to be made. Seniors or other bargaining unit employees may be designated as IDRS Security Alternates and perform all related security matters during periods when they are officially acting in a managerial capacity.

2. District Office and Appeals Organization

   a. The District Director in each district will designate a data security analyst in the Information Systems Division as the district IDRS Security Officer. This individual must be a non-bargaining employee.

b. One IDRS divisional security representative shall be designated for each division, with additional functional representatives as needed within each division or organizational component. Small divisions or organizational components may be serviced by a representative from a larger organization.

c. In those posts of duty where IDRS terminals are shared between functions on a routine basis, the Director's Representative shall be responsible for any security problems (physical or data) relating to the terminal(s). Problems that can be associated with a particular employee shall be the responsibility of the appropriate divisional or organizational IDRS security representative or alternate.

d. Each divisional IDRS security representative shall be responsible for maintaining a current list of his/her division's designated IDRS functional security representatives. The list shall be updated as necessary and provided to the appropriate district office IDRS Security Officer. The list should contain the name of each IDRS security representative, his/her telephone number and the organization(s) serviced.

e. The divisional IDRS security representative and the IDRS functional security representatives must be non-bargaining unit employees due to the sensitive nature of the information contained on the IDRS security reports and the management decisions that will be required to be made. Seniors or other bargaining unit employees may be designated as IDRS Security Alternates and perform all related security matters during periods when they are officially acting in a managerial capacity.

E. OVERALL RESPONSIBILITY

Overall responsibility for the IDRS Security program lies with the Head of Office in each District or Service Center. The Head of Office will ensure that adequate time, training and support is provided to the designated security personnel to allow them to perform their assigned tasks. Sufficent latitude must also be given to allow cross-functional communications between district, service center, inspection and functional representatives.

F. RESPONSIBILITY OF DESIGNATED SECURITY PERSONNEL

1. Service Center

a. IDRS Security Officers have overall responsibility for administrating the IDRS security program. Duties include but are not limited to:

1. Manage the service center IDRS security program and provide assistance to district and regional personnel.

2. Maintain required files, records and documentation.

3. Establish, monitor and update IDRS command code profiles.

4. Add new and returning users to IDRS security data base.

5. Assign replacement passwords to users.

6. Control and issue additional passwords to district office security representatives.

7. Assign IDRS employee numbers.

8. Coordinate IDRS security training for employees, security representatives and management as needed.

9. Distribute IDRS security reports to management, periodically review the reports and maintain documentation of certification of authorized/unauthorized accesses.

10. Distribute and maintain IDRS security handbooks and memoranda.

11. Perform analyses of user accesses to determine improprieties or abuse.

12. Provide assistance to district IDRS Security Officer on security related problems.

13. Conduct IDRS security briefings with district office security personnel annually.

14. Ensure upper management and labor relations are informed of IDRS security problems which may require disciplinary action.

b. The functional IDRS security representative shall be responsible for but not limited to:

1. Requesting new IDRS unit command code profiles.

2. Requesting updates to existing unit command code profiles.

3. Requesting the addition of new or returning IDRS users.

4. Control Issuance of IDRS passwords for IDRS users.

5. Locking, unlocking and deleting IDRS users (ATSC ONLY). At MSC, this will be requested on Form 5081 to Security Staff.

6. Coordinate with the service center Security Officer the creation of new IDRS units within their area of responsibility.

7. Monitor user's command code usage/non-usage, sinon/sinof ratio and sensitive accesses.

8. Unlock IDRS terminals and determine if any security risk exists.

9. Review IDRS security reports and make recommendations to management when problems are detected.

10. Conduct preliminary reviews of potential IDRS security violations and report as appropriate.

11. Advise users of IDRS security rules, secure and forward signed terminal rules to the service center IDRS Security Officer.

12. Conduct periodic IDRS security awareness briefings with new and returning IDRS users.

13. Submit Forms 5081 to the security staff for appropriate requests.

14. Maintain documentation of all regular security reviews or any real or potential security risks identified and advise the IDRS Security Officer.

c. Managers of units having IDRS capabilities have overall responsibility for all IDRS security matters within their unit. All levels of management have the responsibility to assure compliance with IRM 1(16)12, Manager's Security Handbook. In addition, management will evaluate the effectiveness of the IDRS security program and assure the position descriptions of the IDRS security representative accurately reflect IDRS security responsibilities.

2. District Office

a. Districts will appoint a Data Security Analyst within the Information Systems Division as the IDRS Security Officer for the district. The IDRS Security Officer has overall responsibility for administering the IDRS security program. Duties include but are not limited to:

1. Manage the district IDRS security program and provide assistance to the service center IDRS Security Officer as required.

2. Maintain required files, records and documentation.

3. Periodically review and monitor district IDRS command code profiles.

4. Control issuance of passwords and replacement passwords.

5. Coordinate security training for employees, security representatives and management as needed

6. Periodically review and distribute IDRS security reports to divisional representatives and management as appropriate, maintain documentation of certification of authorized and unauthorized accesses.

7. Perform analyses of user accesses to determine improprieties or abuse.

8. Provide direction to divisional IDRS security representatives regarding IDRS security problems.

9. Evaluate the IDRS security program in each function annually as part of the compliance review.

10. Ensure upper management and labor relations are informed of IDRS security problems which may require appropriate disciplinary action.

c. The divisional/functional IDRS security representative shall be responsible for but not limited to:

1. Requesting new IDRS unit command code profiles.

2. Requesting updates to existing unit command code profiles.

3. Requesting the addition of new or returning IDRS users.

4. Requesting replacement passwords for IDRS users.

5. Locking, unlocking and deleting IDRS users.

6. Coordinate with the service center and district Security Officer the creation of new IDRS units within their area of responsibility.

7. Monitor user's command code usage/non-usage, sinof/sinon ratio and sensitive accesses.

8. Unlock IDRS terminals and determine if any security risk exists.

9. Review IDRS security reports and make recommendations to management when problems are detected.

10. Conduct preliminary reviews of potential IDRS security violations and report as appropriate.

11. Advise users of IDRS security rules, secure and forward signed terminal rules to the service center IDRS Security Officer.

12. Conduct periodic IDRS security awareness briefings with new and returning IDRS users.

13. Submit Forms 5081 to the service center security function for appropriate requests.

14. Maintain control of unassigned password envelopes and assure that assigned passwords are delivered to users properly.

15. Maintain documentation of all regular security reviews or any real or potential security risks identified and advise the district IDRS Security Officer.

c. Each divisional IDRS security representative with assistance from the district IDRS Security Officer shall conduct training sessions at least annually for his/her functional security representatives. The training shall include both security awareness and technical aspects of IDRS security. The divisional IDRS security representative is responsible for coordinating with the service center IDRS Security Officer to assure that ample supplies of IDRS security representative training material is available.

d. Managers of functions having IDRS capabilities have overall responsibility for all IDRS security matters within their function. All levels of management have the responsibility to assure compliance with IRM 1(16)12, Manager's Security Handbook. In addition, managers will evaluate the effectiveness of the IDRS security program and assure the position descriptions of the IDRS security representative accurately reflect IDRS security responsibilities.

3. Notification of Suspected Improper Access or (Attempted or Completed)

a. The appropriate Division Chief and labor relations will be notified when any of the following situations are identified:

1. Any access or attempted access of the employee's own or spouse's account.

2. Unauthorized access or attempted access of other employee's or employee spouse's accounts.

3. Any other unauthorized access or attempt such as access to neighbor, friend, former spouse, relative, celebrity or any account in which the employee may have a personal or financial interest.

b. Inspection will be notified of any situations listed in Section 3.a of this document if the investigation reveals:

1. The access includes any unauthorized update of information.

2. The access results in illegal personal or financial gain to the employee or taxpayer.

3. The access or may reasonably result in criminal prosecution.

4. When there is a doubt as to whether the offence is criminal or administrative in nature.

c. The notifications listed in Section 3.b of this document will be performed in accordance with the procedures listed below:

1. The official who determines that a suspected improper access has occurred, is responsible for notifying the appropriate division chief, Labor Relations, Inspection, and the Security Officer.

2. The Security Officer for the service center or district operation will perform the appropriate notifications when an employee has accessed their own or spouse's account. This notification must be a written memorandum.

3. The Security Officer, IDRS security representative or manager performing the initial investigation will inform the appropriate parties when a determination that the criteria listed in Section 3.a of this document has been met.

d. The Security Officer will periodically receive statistical information from labor relations on IDRS related disciplinary action taken within the organization.

e. Labor Relations will maintain an open case on any suspected improper access until such case is resolved.

4. Training of IDRS Security Officers

A regional CPE will be provided annually for service center and district IDRS Security Officers.

G. MAXIMUM PROFILE AUTHORIZATION FILE (MPAF) AND UNIT COMMAND CODE PROFILE (UCCP)

1. The Service Center IDRS Security Officer, in coordination with the District Office IDRS Security Officer, appropriate management and Divisional IDRS Security Representatives shall establish and maintain a MPAF and UCCP for each unit in their area of responsibility. Local Profile Authorization Form 500-5-890 shall be used when requesting new IDRS unit establishment. This form must be signed by the first line manager and the Division Chief before transmitting to the service center. The service center IDRS Security Officer will review the request, perform the required functions and maintain the request as a permanent record.

2. The addition/deletion of command codes to/from the UCCP/MPAF must be submitted to the service center IDRS Security Officer on Form 5081, IDRS Security Files Change Notification. This form must be signed by the first line manager and IDRS security representative.

3. Requests for the addition of sensitive command code combinations to the MPAF, (See Attachment 2), must be approved by the Division Chief.

4. UCCPs and MPAFs must be evaluated and authorized annually by the first line manager. A copy of the unit's MPAF/UCCP will be provided by the service center IDRS Security Officer for this purpose.

H. FORM 5081, IDRS SECURITY FILES CHANGE NOTIFICATION

1. District Offices and Service Centers

a. All IDRS security representatives are responsible for the timely submission of Form 5081, IDRS Security Files Change Notification to the Service Center IDRS Security Officer. Form 5081 will be prepared for the circumstances shown in Attachment 3. Forms will be accurately prepared and properly authorized before submission to the IDRS Security Officer.

b. The IDRS Security Officer will verify that an appropriate security investigation has been initiated or completed for all users. This verification can either be requested from the Personnel Branch or by securing a copy of the employee PERMITS listing. No user may be added to IDRS without an appropriate security investigation being either initiated or completed by the employing office.

c. The service center IDRS Security Officer may receive telephonic requests from the district offices for the addition of new/returning users, command code changes and password replacement only if a work stoppage situation is involved. Telephonic requests must be verified by the submission of Form

5081 immediately. If verification is not received, a cancellation of the request may be imposed by the Security Officer.

I. DELETING EMPLOYEES FROM THE EMPLOYEE PROFILE SECURITY FILE

1. It is the responsibility of the unit or first line manager to delete employees who no longer need access to IDRS. In no case should an employee continue to have access to IDRS more than three working days after they meet the criteria for deletion as specified in handbook guidelines.

2. With the addition of the systemic profile lock feature, a user's access to IDRS is temporarily suspended if the user does not access the system within a 17 calendar day period. Managers shall review the Security Profile Report to identify users who have been locked and should be deleted. In no case should a user remain locked for a period exceeding 45 calendar days.

J. SENSITIVE IDRS COMMAND CODES

1. Certain IDRS command codes are deemed sensitive when they have the ability to update or change either the tax or entity module of the account. Under no circumstances should sensitive command codes be placed in a unit's UCCP. Sensitive command code combinations within employee's profile, should be limited only to those command codes necessary for the employee to accomplish his/her official duties. It is the responsibility of the manager to review the command codes in his/her unit's UCCP/MPAF and to notify the IDRS Security Officer when command codes are no longer needed. A list of sensitive command code combinations is located in Attachment 2 of this document.

2. Security command codes are also sensitive command codes and should appear only in the EPSF of employees performing security duties and a unit's MPAF.

K. IDRS AUDIT TRAIL

1. All accesses to IDRS are recorded on the Audit Trail file. The IDRS Security Officer should make periodic searches of the Audit Trail file to determine if questionable activity is present. Any detection of such activity should be reported as outlined in Section E.3 of this document. Any request for access to the Audit Trail file by management or a security representative should be in the form of a memorandum to the IDRS Security Officer at the appropriate service center or district office.

L. SECURITY REPORTS

1. Data Systems Security Report (DAILY)

a. The Data Systems Security Report is a listing that contains four separate reports:

1. Terminal Lock/Unlock - Incomplete Security Command Code Report;

2. Completed Security Command Code Report;

3. Security Violations Report;

4. Sensitive Access Report.

These reports are produced daily and reflect all information from the previous work day. The service center IDRS Security Officer shall review these reports for questionable entries and report as outlined in Section E.3 of this document.

2. Managers Weekly Security Report

a. This report is produced weekly and is intended to keep management informed on their employees accesses to IDRS. The unit manager is responsible for verifying that all accesses made by employees assigned to his/her unit were for official purposes. The manager must certify the validity of these accesses to the IDRS Security Officer by signing a statement to that effect.

b. Accesses made by employees to own or spouse accounts will be referred as specified in Section E.3 of this document. Employees will be interviewed in accordance with the NTEU agreement to determine the circumstances of the access.

c. The service center IDRS Security Officer is responsible for notifying the district IDRS Security Officer of any access made by a district office employee to their own or spouse's account.

d. Instances of typical abusive accesses that should be analyzed are:

1. Inputs that affect the account/module balance and tax liability or change the entity module;

2. Inputs that change the account status;

3. Employees looking up each others' accounts;

4. Instances of employees accessing unusual numbers of employee's or employee spouses' accounts;

5. Inputs for no obvious reason.

e. IDRS and source documents shall be researched as needed to identify potential improprieties.

f. If the analysis of an access indicates there may be criminal intent, the investigation will be stopped and inspection informed.

g. Review of the Managers Weekly Security Report will be fully documented.

3. IDRS SECURITY PROFILES REPORT

a. The Security Profiles Report is produced both monthly and quarterly. This report shall be reviewed by the IDRS Security Officer and management. Command code profiles, command code accesses (high as well as low volume) shall be evaluated for the purpose of identifying excessive usage to indicate the possibility of browsing or monitoring. Command codes having no usage for three consecutive months shall be considered for removal. Evidence of sensitive command code combinations shall be closely monitored and analyzed. Suspicions of abuse shall be further analyzed.

b. The sinof/sinon ratio for unit organizations shall be maintained at 94 percent or better.

c. Employee's profiles that have been locked shall be reviewed by management to determine the need for that employee to remain an active IDRS user. The manager shall be responsible for making that determination but under no circumstances shall the employee remain locked for longer than 45 calendar days at which point the Security Officer will initiate deletion of the employee from IDRS.

M. EMPHASIS PLACED ON IDRS SECURITY

1. A greater emphasis must be placed on IDRS security in the Southeast Region. To do this, all areas of management must resolve to promote a more intensified awareness and involvement in the security program. IDRS is one of the most effective tools the Service employs and the information contained therein must be protected from abuse. All employees must participate in the promotion of good security practices and understand that abuses will not be tolerated. To accomplish this management must:

   a. Provide all employees with ample time to be presented with a security awareness program that will advise them of what to do and what not to do while using the Service's computer systems.

   b. Establish a procedure for dealing with system abusers and support disciplinary actions against such abuses.

   c. Keep an open mind when advised of inadequate or ineffective security practices when advised by security personnel.

   d. Strive to advance a more positive attitude to employees and instill the employee's dedication to the security program.

Michael P. Dolan
Regional Commissioner

Attachments (3)

Attachment 1

DEFINITIONS

AUDIT TRAIL FILE

The Audit Trail file is a record or all transactions effected through IDRS. This file can be searched by any definable character included in the record.

DIVISIONAL IDRS SECURITY REPRESENTATIVE

An employee appointed by a Division Chief in the district office to administer the IDRS security program for that particular division. This employee may be responsible for more than one division or organization if the number of IDRS users is small.

EMPLOYEE PROFILE SECURITY FILE (EPSF)

This security file contains only the command codes that are authorized for the individual employee to use. No command code shall be placed in the EPSF that is not shown in the MPAF. Command codes that are placed in the EPSF that are not authorized in the MPAF cannot be used and must be removed immediately.

FORM 5081, IDRS SECURITY FILES CHANGE REQUEST

Form 5081 is the basic tool used to request services to employees and unit/maximum profiles. This form shall be prepared by the unit manager and authorized by the unit or divisional security representative. This form must be accurate to assure the employee is correctly entered on the IDRS security file.

IDRS SECURITY OFFICER

The service center Security Analyst or the district office Data Security Analyst that is specifically charged with the responsibility of administrating the IDRS security program. This employee has overall authority to make decisions affecting the IDRS security program for the service center and the district offices serviced by that center. This employee will reside in the IS Staff as per Section E.2.a. of this document and must be non-bargaining.

IDRS SECURITY REPRESENTATIVE

A non-bargaining unit employee, preferably a first line manager, who is responsible for the administration of IDRS security at the user level. This employee should be appointed jointly by the next higher level of management or the divisional security representative and the IDRS Security Officer.

LOCKED PROFILE

An employee's security profile can become locked both manually and systemically. This temporary feature will disable any attempt to gain access to IDRS. The users password remains in effect but will not allow the "pass-through" to information files. The profile must be unlocked by the security representative or IDRS Security Officer.

MANAGER

First line or immediate manager of employees having IDRS access.

MANAGERS WEEKLY SECURITY REPORT

This report is produced in two parts. Part one identifies security violations that were committed by employees assigned to a particular unit. This portion should be reviewed by the unit manager to determine if there are possible security breaches that should be addressed. The second part contains sensitive accesses made by employees of the unit to own/spouse and other employee's or employee spouse accounts. Accesses shown on this part of the report must be reviewed by the unit manager to determine if accesses were authorized.

MAXIMUM PROFILE AUTHORIZATION FILE (MPAF)

This security file contains all command codes that are authorized for a particular unit to use. No one employee in the unit should have access to all command codes in the MPAF.

SECURITY PROFILES REPORT

A security report that is generated monthly/quarterly to provide information to the unit manager on the activity of employees in their respective areas of responsibility. This report should be reviewed thoroughly by the unit manager to enable them to be kept informed as to what type of activity their employees are engaged in on IDRS. This report should never be used as a performance tool but rather to identify the existence of possible security problems.

UNIT COMMAND CODE PROFILE (UCCP)

This security file contains only the command codes that are authorized for all users in the unit to have. This file will contain NO sensitive or restricted command codes. When users are added to IDRS they will automatically receive all of these command codes unless otherwise directed on the Form 5081.

SENSITIVE COMMAND CODES

ADJ47	BRCHG	FRM14	IPSUP	TSIGN
ADJ54	CCPYT	FRM34	LEVYD	UPRES
AMAXU	CHK64	FRM49	NOREF	URADD
AMRED	DELET	FRM77	PAYMT	URAPL
AMSOC	DOALL	FRM7A	QRACN	URENT
AMSTU	DRT24	IAORG	REFAP	URNCH
BDADD	DRT48	IAREV	RFUND	URREF
BDAPL	EOCHG	INCHG	RMODE	XSADD
BDENT	EPLAN	INTEL	STAUP	XSAPL
BDOUT	ESTAB	IPSAD	TDIAD	XSENT
BNCHG		IPSST		XSREF

THESE COMMAND CODES MUST BE CLOSELY MONITORED BY MANAGEMENT IF PRESENT IN THE EMPLOYEE'S PROFILE.

SENSITIVE COMMAND CODE COMBINATIONS

PAYMT	URAPL	XSAPL	SCFAJ	RFUND	REFAP	UPDIS	STAUP
ADC24	ADC24	ADC24	ADC24	REFAP	RFUND	UPRES	TSIGN
ADC48	ADC48	ADC48	ADC48	INCHG	INCHG		
ADD24	ADD24	ADD24	ADD24	BNCHG	BNCHG		
ADD34	ADD34	ADD34	ADD34				
ADD48	ADD48	ADD48	ADD48				
ADJ47	ADJ47	ADJ47	ADJ47				
ADJ54	ADJ54	ADJ54	ADJ54				
DRT24	DRT24	DRT24	DRT24				
DRT48	DRT48	DRT48	DRT48				
BNCHG	BNCHG	BNCHG	BNCHG				
INCHG	INCHG	INCHG	INCHG				
	URADD	URADD					

IF COMMAND CODE ABOVE THE SOLID LINE IS PRESENT IN THE EMPLOYEE'S EPSF, THE COMMAND CODES LISTED DIRECTLY UNDERNEATH SHOULD NOT BE PRESENT UNLESS THEY ARE CLOSELY MONITORED BY MANAGEMENT.

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Attachment 3

SUBMISSION OF FORM 5081

Forms 5081 shall be submitted to the service center IDRS Security Officer for the following actions:

1. when adding a new or returning user to IDRS;

2. when adding/deleting <u>security command codes</u> to/from employee's profile;

3. when adding/deleting command codes to/from UCCP/MPAF;

4. when changing the employee's name on IDRS;

5. when changing an employee's Social Security Number on IDRS.

The service center IDRS Security Officer may require the submission of Forms 5081 for certain other actions taken on IDRS. This request will be on an exception basis, and the requestor will be notified.

Attachment IV

Internal Revenue Service
M E M O R A N D U M

date: OCT 23 1991

to: All District and Service Center Directors
Southeast Region

from: Regional Commissioner
Southeast Region

subject: Integrated Data Retrieval System Security Program

Regional Inspection has recently conducted a study of data security and controls over the Integrated Data Retrieval System (IDRS) within the SER. They have completed their review of most of the offices and will be finishing their review of the rest of the offices within the next few weeks.

The purpose of this memorandum is to forward the initial results of Inspection's study via miscellaneous information items, to provide guidance concerning the control and disposition of cases/information resulting from this study, and to advise you of additional actions that are being implemented to improve the security of the IDRS within the SER.

Included with this memorandum are miscellaneous information items related to the study conducted in all offices with the exception of Columbia, Ft. Lauderdale, Jackson, Nashville, and New Orleans District Offices. Items related to those offices will be forwarded to Directors within the next few weeks.

The miscellaneous information items indicate that an IDRS security violation may have occurred. While the information forwarded by Inspection reflects their initial analysis of the taxpayer accounts in question, they do not plan to initiate a conduct investigation of these accounts. The information is being forwarded for administrative investigation and action as deemed appropriate by local management. If, in conducting its internal investigation, management determines the violation may represent possible criminal action (i.e., violation other than unauthorized access such as unauthorized updating of accounts) the matter should be referred back to Inspection for reconsideration of further investigation by their office.

THIS DOCUMENT CONSTITUTES OFFICIAL GUIDANCE TO MANAGERS

All District and Service Center Directors
Southeast Region

The miscellaneous information items should be controlled by your local Labor Relations office including being entered into the Automated Labor and Employee Relations Tracking System (ALERTS). Upon completion of the appropriate disposition of the items, ALERTS should be updated in accordance with required procedures.

Miscellaneous information items will require further investigation by the functional managers including interviewing their employees as appropriate. To assist your managers in conducting these investigations, Attachment I lists some of the possible indications that security violations may have occurred. Attachment II identifies some of the sources that Internal Audit used to identify relationships between employees and taxpayers they accessed in order to determine if the access was unauthorized and provides guidance to assist managers in conducting employee interviews. In addition, local IDRS Security Officers may be utilized as resource persons to assist managers in identification of security violations based on the information provided in the miscellaneous information item. Also, local Labor Relations will receive guidance from Regional Labor Relations and will provide assistance to managers concerning conducting the employee interviews.

Managers should be creative and thorough in conducting the administrative investigation. Labor Relations should provide managers with guidance concerning any applicable provisions of the IRS-NTEU Agreements in conducting investigatory interviews of bargaining unit employees. Specifically, the provisions of Article 5, section 4I will apply if the case involves the employee accessing his/her own or spouse's account, or making an unauthorized inquiry of another employee's (or spouse's) account. Article 38, section 1D and Article 39, section 1D are applicable for <u>all</u> interviews with employees concerning possible IDRS security violations.

When conducting the investigative interview with employees, managers should not advise employees at that time of the potential disposition of the case (i.e., counseling, documentation, disciplinary/adverse action). Rather, upon completion of the administrative investigation, managers should consult with their higher-level functional managers and with their local Labor Relations staff to determine appropriate disposition of each case including consistency of penalty as appropriate. It is recommended that Labor Relations develop

THIS DOCUMENT CONSTITUTES OFFICIAL GUIDANCE TO MANAGERS

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All District and Service Center Directors
Southeast Region

a spreadsheet and/or utilize the ALERTS system to assure consideration of all relevant factors and consistency of actions within and across divisional lines as appropriate. Regional Labor Relations is available to provide any assistance/guidance requested of them by your local Labor Relations specialist(s) to assist in assuring appropriate consistency of action.

If the administrative investigation reveals no violation of IDRS security rules, the results of the investigation should be documented and referred to local Labor Relations in order for them to close out the item and enter a disposition of "no violation found/no action required" into the ALERTS system. If the administrative investigation indicates any violation of IDRS security rules (including lessor violations such as careless/negligent/inadvertent unauthorized access) some action must be taken (i.e., counseling with documentation of such or disciplinary/adverse action). Managers should not simply report "no action taken" if it has been determined that any violation has occurred.

In determining what action is appropriate, managers should bear in mind that the Service does not have a table of offenses and penalties for use in adjudicating IDRS or other employee misconduct. However, the Service is obligated to consider consistency of penalties with those imposed upon other employees for the same or similar offenses. Close coordination within each division, across division lines and consultation with Labor Relations will assist in accomplishing an appropriate level of consistency of actions taken from documented counseling to adverse action.

To assist offices in making threshold decisions and appropriateness of action determinations, the guidance reflected in Attachment III has been developed for management to utilize in considering/evaluating each case both on its own merits and as it relates to consistency with other cases. This guidance is not intended to serve nor should it be viewed or used as a table of penalties. Rather, it is meant to serve as an additional tool (along with consideration of the facts and circumstances in each case including required consideration of the traditional "Douglas factors") for offices to use in making sound, well-analyzed judgments related to IDRS security violation issues.

All District and Service Center Directors
Southeast Region

With regard to NTEU-related implications, as previously indicated, all applicable provisions of NORD III/NCA III must be followed. Also, while there is no provision/obligation for local negotiations related to the disposition of these referrals, you may wish to discuss with your local NTEU Chapter President/Joint Council Chairperson management's current and continuing efforts to improve the security of the IDRS within the SER, including dealing with the results of Inspection's recent study.

In addition to receiving the miscellaneous information items from Inspection, you will be receiving at a later date reports of conduct investigations completed by Internal Security. These reports will reflect a finding that an IDRS security violation occurred and that the case was referred for potential criminal prosecution. These cases should be processed in the same manner as any conduct case from Inspection. In addition, Regional Labor Relations will monitor the proposed and completed disposition of each of these cases with regard to appropriateness and consistency of action taken.

In addition to taking action related to Inspection's findings, the SER is in the process of implementing a long-term action plan to increase the protection of the integrity and improve the security of our IDRS.

As indicated in the memorandum dated September 30, 1991, to all Directors from ARC (Data Processing) and ARC (Resources Management), subject "Improvement of IDRS Security," specific actions will be taken during the next few months to strengthen IDRS security in all offices. In addition to those actions outlined, there will be an increased emphasis on and expectation for first line managers of IDRS users and all levels of IDRS security personnel (security officers/analysts/technicians, divisional, functional and unit representatives) to be actively involved in the identification and investigation of possible IDRS security violations. The upcoming revision of RC-SE memo 1(16)22 will outline the roles, responsibilities and procedural requirements related to IDRS security. The RC-SE memo will include a requirement that, in some cases, possible instances of security violations (as determined locally rather than via Inspection) must be referred to your local Labor Relations office for control and appropriate disposition similar to the guidance provided above for Inspection-generated referrals. Regional Labor Relations will provide further guidance concerning the processing of locally identified security violations.

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All District and Service Center Directors
Southeast Region

As we progress in the field of tax administration and service to the public, it is imperative that we protect the integrity of all of our computer systems. I appreciate your efforts and those of your staff in adjudicating the referrals from Regional Inspection and your continued support in improving the security and integrity of our Integrated Data Retrieval System.

If you have questions, please contact me or members of your staff may contact Susan Anderson on FTS 841-6027.

Michael P. Dolan
Regional Commissioner

Attachments: Inspection Miscellaneous Information Items
Attachments I, II, III

cc: Assistant Regional Commissioners
Regional Inspector
Regional Director of Appeals
Assistant Regional Counsel, GLS
Chief, Regional Office Personnel Section

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Attachment I

Taxpayer's address and/or name similar or the same as the employee's

Groups of taxpayers with similar or same names and/or addresses

Employees without inventories of cases accessing the same taxpayer during different filing seasons

Multiple taxpayers with Post Office Box addresses

Taxpayers accounts with Social Security Numbers within a few numbers of the employee's SSN

Multiple taxpayers with addresses in the same zip code as the employee

Attachment II

SOURCES

Official Personnel File (names and addresses of relatives and references, maiden names, prior addresses, handwriting samples)

Master file transcripts (addresses, names of spouses, cross reference SSNs)

Tax returns (names of spouses and dependants, current addresses, dependant SSNs)

IDRS (INOLE for prior name control, cross reference SSNs)

CONDUCTING EMPLOYEE INTERVIEWS CONCERNING IDRS ACCESSES

Since there exists numerous personal reasons for an employee to access a taxpayer account circumstances must be reviewed to determine the best approach. Consideration must be given to the nature of the position of the employee and their normal use of the IDRS terminal. Accesses to accounts of relatives, friends, and neighbors, can sometimes become evident with a review of their personnel folder to identify listed relatives, references, and their current and former residences. The interview should be structured so that the accounts with a known definite relation are questioned first. A review of the remaining accounts should identify accesses inconsistent with their normal IRS use of IDRS. Interviewer should next address the accounts which reflect the most abnormal accesses. Do not differentiate these accounts to the employee.

After the accounts are ranked, the questions pertaining to the accesses should begin with positive identification of the taxpayer. If the taxpayer is a relative, establish the relationship. If the taxpayer is a friend, establish how the employee knows this person (former co-worker, childhood friend, high-school friend, friend of a friend). If the taxpayer is identified as a neighbor, establish which neighborhood the taxpayer is known from (current neighbor, former neighbor, neighbor of friend or relative). Establish the most recent time the employee talked with the person and how often the employee has contact with this person. If the employee does not acknowledge a relationship and there is contradicting evidence, confront the employee with this evidence.

Next, attempt to identify why the account was accessed. Was the employee asked to access the account by the taxpayer to obtain some specific information? Was the employee asked by someone other than the taxpayer to access the account to obtain some specific information? Did the employee access the account because of their own curiosity? Did the taxpayer have a legitimate reason to request research of his account? How did the person come to ask the employee to access the account (in-person, telephone, through another person)? Did the employee discuss their findings with anyone (taxpayer, co-worker, others)?

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Attachment II (Continued)

Request that the employee explain how they proceeded to extract this information from the IDRS system and what command codes they used or probably used (RTINF, FFINQ, SSNAD, etc.).

At this point, it may be advantageous to review the audit trail to compare the information received by the employee to identify any discrepancies.

Attempt to establish if the employee had any other IRS involvement in the account of the taxpayer, i.e., preparation of the tax returns, forms, or supporting documentation.

Did the employee receive management approval to access the account for some unusual reason or circumstance?

Did the employee receive any IDRS security training and of what type (speech, video instruction tape, or management directive)?

If the information provided by the employee and the information obtained from reliable sources (i.e., IDRS audit trails, IDRS Masterfile Transcripts, Employee's Personnel File, etc.) does not coincide this could be an indication of deception and could require additional inquiries.

ATTACHMENT III

GUIDELINES FOR DETERMINING APPROPRIATE ACTION IN IDRS SECURITY VIOLATION CASES

*Note: If the IDRS violation was not a first offense or if there are other aggravating considerations, a more severe action may be appropriate.

TYPE OF VIOLATION	THRESHOLD ACTION
Employee accessed own account; access inadvertent or due to carelessness; first offense; no evidence of any additional IDRS violation.	Documented Counseling*
Employee accessed own account; access intentional; first offense; no evidence of any additional IDRS violation.	Admonishment Confirmed in Writing*
Employee accessed spouse's (or former spouse's) account or another employee's (or spouse's or former spouse's account; first offense; no evidence of any additional IDRS violation.)	Written Reprimand*
Employee accessed account of taxpayer in which employee has a personal or financial interest or taxpayer account not required to accomplish employee's official duties (such as account of a friend, relative, neighbor, celebrity, etc.); first offense; no evidence of any additional IDRS violation.	Written Reprimand*
Employee failed to sign off IDRS; failure inadvertent or due to carelessness; first offense; no evidence of any additional IDRS violation.	Documented Counseling*
Employee failed to sign off IDRS; failure intentional; first offense; no evidence of any additional IDRS violation.	Admonishment Confirmed in Writing*
Employee used command code not in employee's profile; use inadvertent or due to carelessness; first offense; no evidence of any additional IDRS violation.	Documented Counseling*

ATTACHMENT III (Continued)

Employee used command code not in employee's profile; use intentional; first offense; no evidence of any additional IDRS violation.	Admonishment Confirmed in Writing*
Employee used another employee's password to access IDRS; first offense; no evidence of any additional IDRS violation.	Written Reprimand*
Employee used IDRS to prepare tax return not for compensation, gift, or favor; first offense; no indication of any additional IDRS violation.	Written Reprimand (Note: if tax prepared for compensation, action taken would be more severe depending on additional aggravating circumstances and offenses).
Employee prepared/monitored returns; no evidence of false adjustments/entries or financial gain by the employee/taxpayer.	Written Reprimand. (If employee was previously disciplined for an IDRS violation, a more severe action may be appropriate such as suspension)
Employee entered false adjustments via IDRS and monitored the taxpayer's account; financial gain to employee/taxpayer.	Removal
Employee prepared and monitored returns and misrepresented the income or expenses of taxpayer; financial gain to employee/taxpayer.	Removal
Employee obtained taxpayer information and disclosed such information to unauthorized persons; no evidence of any additional IDRS violation.	Suspension/Removal (Note: Coordinate with Disclosure Officer concerning violation.)

Attachment V

INTERNAL REVENUE SERVICE
MEMORANDUM

date: SEP 30 1991

to: All District and Service Center Directors D
Southeast Region

from: ARC (Data Processing) D:IS
ARC (Resources Management) RM:B/LR
Southeast Region

subject: Improvement of Integrated Data Retrieval System (IDRS) Security

As discussed in the last executive conference, in a recent study of IDRS security made by the Office of the Regional Inspector, there were several instances of user abuse. These system abuses included "browsing," tracking refunds for friends and relatives, issuance of fraudulent refunds, and other such unethical, illegal activities.

A task force was formed at the request of the Regional Commissioner to work closely with the Regional Inspector's Office to identify system abuse and improper access by IDRS users. They also have identified ways to strengthen IDRS security through increased employee awareness, increased management involvement, and consistancy in disciplinary actions in cases of IDRS misuse. In July 1991, the task force presented to all Information Systems chiefs an overview of "today's" IDRS security and what we need to do to improve it.

Toward this end, you will be receiving additional information on the following actions which will be taken during the next few months:

- complete recertification for all IDRS users;
- issue a revision of the RC-SE Memorandum 1(16)22 addressing the roles, responsibilities, and procedures related to IDRS security;
- conduct a combined workshop for service center and district office security analysts;

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All District and Service Center Directors
Southeast Region

- present an IDRS security overview to all managers of all functions and support personnel whose work is directly related to IDRS usage (i.e., Labor Relations personnel); and

- conduct IDRS security refresher training for all service center and district office functional security representatives.

To effectively accomplish these actions, all levels of management must resolve to promote a more intensified awareness of and increased involvement in the IDRS security program. Your commitment to this on-going effort is appreciated.

If you have any questions, please contact Dianne Dempsey, Information Systems Program Manager, at (404) 331-7010 or (FTS) 841-7010 or Susan Anderson, Labor Relations Specialist, at (404) 331-6027 or (FTS) 841-6027.

cc: Regional Commissioner
Regional Inspector
Regional Appeals
Regional Counsel
All Assistant Regional Commissioners and Staff
Chief, Regional Office Personnel Section

Reference No. 030103 Date: October 23, 1992

REVIEW OF CONTROLS OVER IDRS SECURITY

DIGEST

This report presents the results of our National Audit of controls over the Integrated Data Retrieval System (IDRS). We initiated the review after identifying national implications of control weaknesses over IDRS security during an Inspection Integrity Project.

For almost 20 years, the IDRS has been the primary computer system for accessing and adjusting taxpayer accounts. In the early 1970's, the taxpayer accounts on IDRS were limited primarily to delinquent or notice accounts. There were fewer users on the system and adjustment authority was highly restricted. To enhance taxpayer service, IDRS has evolved into a system that provides employees with almost immediate access to taxpayer accounts and gives more employees adjustment authority. Nationwide, there are approximately 56,000 IDRS users. However, Service management did not assure that the IDRS security system kept pace with significant changes in user capabilities.

We identified the following areas that need management attention:

- Controls do not adequately monitor employee actions taken on the system. Our tests showed that the available security reports, guidelines and training materials are often not effective in helping security personnel identify potential employee misuse of IDRS.

- Disciplinary actions taken against employees who violate IDRS security rules are not consistent. The Service has not established specific guidelines to ensure that disciplinary actions imposed are consistent.

- The IDRS security program does not have the managerial emphasis needed to ensure its effectiveness. The unit security representatives are not given formal expectations for IDRS security and their IDRS security duties are generally not evaluated. The unit security representatives are inconsistently trained and are not given instructions on how to detect potential employee misuse of IDRS.

Ineffective security controls over IDRS allowed employee fraud to occur. A recent integrity project in the Southeast Region on command code REINF usage found strong indicators that 368 employees used IDRS to monitor non-work related accounts, including those of friends, relatives, associates, neighbors or celebrities. The command code REINF is used to determine if a taxpayer's tax return posted to the master file. REINF also shows the amount and date of release for any refund due the taxpayer.

As a result of the integrity review, information on 289 employees was referred to their respective heads of office for administrative follow up and any appropriate disciplinary action. Information on the other 79 employees was referred to Internal Security for evaluation and investigation of potential criminal violations. To date, the investigations have established that six employees prepared fraudulent returns for taxpayers and then monitored the accounts on IDRS. The actions for five of these six employees are being reviewed by the appropriate United States Attorney for potential criminal prosecution.

Ongoing integrity reviews in the North Atlantic and Western Regions also identified administrative cases similar to those in the Southeast. Although their results are incomplete, employees are browsing taxpayer accounts for no clear business purpose.

Taxpayer confidence in the Service's ability to ensure the privacy of tax data is diminished when situations such as those above are identified. Also, ineffective security controls over IDRS increase the Service's vulnerability to acts of unauthorized use of tax information.

To enhance security controls over IDRS, we made a number of recommendations to the National Office, some of which are listed below.

- Strengthen existing security controls over IDRS to allow management and security personnel to more effectively detect IDRS misuse. This could include redesigning the IDRS security system, providing security personnel with adequate hardware and software to proactively detect potential IDRS misuse and revising guidelines and training materials to include guidance on detecting potential misuse of the system.

- Ensure that the security system for Tax Systems Modernization (TSM) has similar controls as those recommended for the current security system for IDRS. The controls should be designed to detect and prevent employee misuse of the system.

- Establish national standards to direct management on the appropriate disciplinary actions to consider when employees violate IDRS security rules. Current Internal Revenue Manual (IRM) guidelines should also be revised to ensure that IDRS violations are consistently dealt with.

- Include IDRS security in the Service's Strategic Business Plan.

- Include articles on IDRS security in national and local publications to increase employee awareness of IDRS security.

- Include specific examples of IDRS misuse in employee ethics training.

- Provide periodic structured training classes to security personnel and managers who supervise IDRS users to ensure everyone is consistently and adequately trained to detect IDRS misuse.

Details of the recommendations are included in the body of the report. Management agreed to implement all of our recommendations. The full management response is included as Attachment III of the report.

REVIEW OF CONTROLS OVER IDRS SECURITY

INTRODUCTION

This report presents the results of our National Audit of controls over the Integrated Data Retrieval System (IDRS). We initiated the review after identifying national implications of control weaknesses over IDRS security during an Inspection Integrity Project.

We conducted the review in the National Office and the North Atlantic, Southeast and Western Regions. On-site interviews and tests were performed in the Andover, Atlanta and Fresno Service Centers, the Portsmouth, Augusta, Atlanta and Laguna Niguel Districts, and the regional offices in the respective regions. We conducted the review in accordance with generally accepted government auditing standards.

BACKGROUND

The Internal Revenue Service (IRS) has become increasingly dependent on automated information systems to accomplish its mission. Each IRS service center maintains a database system, commonly called the IDRS. This system contains sensitive tax information about taxpayers serviced by the respective center. Authorized IDRS users access information through terminals located throughout the service center, regional and district offices. There are approximately 56,000 IDRS users nationwide.

The key to accessing information on IDRS is a password, entry code and command code profile. Each IDRS user is given a unique password and assigned a profile of command codes based on their job requirements. The profiles limit the users to only those command codes needed to do their jobs effectively. After the user signs onto IDRS, they can use the appropriate command code along with the Taxpayer Identification Number (TIN) to access taxpayer accounts. The TIN is used with a command code which tells the computer the action to take.

The two major categories of command codes are research and sensitive. Research command codes are used to query account information on IDRS such as determining when a refund will be issued. Sensitive command codes are used to change account information such as adjusting accounts and transferring credits from one account to another.

The IDRS security controls were instituted in the early 1970's. At that time, IDRS had limitations that do not exist in 1992. For example, in the early 1970's the accounts on IDRS were limited to primarily delinquent or notice accounts. Also, there were fewer terminals and fewer employees with IDRS capabilities in District offices. Adjustment authority was highly restricted and generally limited to groups of service center employees.

District employees now have adjustment capabilities. Also, Tax Systems Modernization (TSM) efforts through initiatives such as Corporate Files On Line (CFOL), have expanded the information employees can access on IDRS. For example, before CFOL employees only had access to accounts serviced by a particular service center. However, CFOL allows employees to obtain nationwide entity and tax return information. This greatly increases the risk of employee browsing, disclosure or fraud.

OBJECTIVES AND SCOPE OF REVIEW

Our objectives were to: (1) determine how the security system for IDRS could more effectively detect improprieties and prevent improprieties from occurring; (2) determine if the planned security for TSM addresses current security problems of IDRS; and, (3) determine if the organizational emphasis placed on IDRS security is consistent with the many legal and ethical requirements to protect taxpayer information. The detailed objectives and scope of review are included in Attachment I to the report.

RESULTS OF REVIEW

Our review showed that controls need improving to adequately monitor actions taken on the system by employees. Our tests showed that the disciplinary actions taken against employees who violate the IDRS security rules need to be more consistent. We also determined that management needs to place more emphasis on the IDRS security program. We discuss these areas below.

CONTROLS OVER THE IDRS SECURITY SYSTEM NEED IMPROVING TO EFFECTIVELY DETECT AND PREVENT EMPLOYEE MISUSE OF THE SYSTEM AND PROTECT TAXPAYER INFORMATION

IDRS is one of the largest computer systems in the IRS that contains sensitive taxpayer information. However, the security system has not kept pace with significant changes in user capabilities over the past 20 years. Each office has security personnel who are responsible for monitoring all IDRS activities; however, the number of full time personnel is limited.

The IDRS security officer has overall responsibility for monitoring the IDRS security program in the service centers and districts. The duties performed generally consist of distributing security reports to the unit security representatives, adding users to the system and assigning profiles for users.

Unit security representatives are responsible for monitoring the IDRS security program and all security matters within their unit. IDRS security is a collateral duty for the unit security representatives and written expectations are usually not given to them. We interviewed 80 unit security representatives in the three regions and most of them have never detected employees misusing IDRS. They generally rely on referrals from the security officer. Inspection or taxpayers.

The tools provided to security personnel are often not effective in helping them identify potential employee misuse of IDRS. The current tools available to security personnel include security reports which identify employees who access their own and their spouse's accounts and the accounts of other employees. Other reports show command code usage and ratios for employees signing on and off the system. These reports do not help security personnel identify potential browsing, disclosure or other integrity problems.

Other tools provided to security personnel are a daily audit trail of accesses to IDRS and a utility program which can be used to search the audit trail. However, neither of these tools can be used efficiently to identify trends of IDRS misuse over a period of time.

Also, the IDRS Security Handbook and training materials provided to security personnel focus primarily on how to administer the IDRS security program. These materials include instructions for issuing passwords and assigning profiles to users, unlocking terminals and distributing security reports. However, these documents do not provide proper guidance to security personnel on how to detect potential employee misuse of IDRS. These documents require security personnel to search the audit trail and review security reports to identify questionable activities and abnormal use of command codes. However, the documents do not define or give examples of questionable activities or abnormal use of command codes.

Public Law, Treasury Directives and Internal Revenue Manual (IRM) guidelines require the IRS to protect the integrity, availability and privacy of taxpayer information on its systems. Adherence to these requirements is even more important in view of the Service's planned TSM projects and the increased emphasis on protecting the privacy of taxpayer information.

Ineffective security controls over IDRS allowed employee fraud to occur. Various Internal Audit reviews and integrity projects identified instances where employees used IDRS for non-business reasons and management was not aware of the non-business use. For example, a recent integrity project in the Southeast Region found strong indicators that 368 employees used IDRS to monitor non-work related accounts, including those of friends, relatives, associates, neighbors or celebrities.

Southeast Region Internal Audit employees used various methods to determine that the above accesses were non-business related. Some of the techniques used were reviewing

IDRS audit trail information for a three year period, analyzing the number of times an employee accessed the same taxpayer's account, comparing the address of the accounts accessed to the address of the employee who accessed the accounts, comparing handwriting on original returns prepared by the employee to the handwriting in personnel files and matching the accounts accessed to inventory files such as the Delinquent Investigation/Account Listing (DIAL) and Problem Resolution Management Information System (PROMIS) to determine if employees were actively working the accounts. The integrity project began as an analysis of command code REINF usage. This command code is used to determine if a taxpayer's tax return posted to the master file. REINF also shows the amount and date of release for any refund due the taxpayer.

We referred information on 289 of the 368 employees to their respective heads of office for administrative follow-up and any appropriate disciplinary action. We referred information on the other 79 employees to Internal Security for evaluation and investigation of potential criminal violations by the employees. To date, Internal Security has referred six cases to the appropriate United States Attorney. Five of the six cases are pending prosecution.

Internal Audit personnel in the North Atlantic and Western Regions also conducted similar integrity reviews of command code REINF usage on a much smaller scale. They identified 25 cases with similar characteristics as those identified in the Southeast Region. For example, one case indicates that an employee is preparing returns for the accessed taxpayers and lives at the same address as one of the accessed taxpayers. In another case, the employee's prior address is the same as the taxpayer accessed. In two other cases, employees accessed the accounts of family members for no clear business reason. Seven cases in North Atlantic Region and 18 cases in Western Region were referred to Internal Security for investigation.

Ineffective security controls over IDRS increase the Service's vulnerability to acts of unauthorized use of official information. Also, taxpayer confidence in the Service's ability to protect the privacy of tax data is diminished when adequate controls are not in place to monitor employee activities.

As the Service moves toward modernizing its tax administration system, care should be taken to ensure that the weaknesses in the present IDRS security system are not carried forward to the system that replaces IDRS. The security system for TSM should provide all the tools needed to ensure the privacy and confidentiality of taxpayer information. As stated by the Chief Information Officer, the IRS has a moral as well as a legal obligation to protect the privacy of individual taxpayer financial information. The IRS' focus should be on preventing incidents rather than responding after one occurs.

Recent thefts of computerized data from various computer systems in government agencies make it even more important that the IRS' security system is designed to detect and prevent potential unauthorized use of information by employees. As information technology advances and users are provided access to more information, the opportunity for breaches of integrity is increased. As the Service transcends into TSM, it is imperative that the privacy of taxpayer information is protected.

Recommendations

The following recommendations should improve existing controls over IDRS security and help ensure that the current problems are not carried forward to TSM.

- Determine the feasibility of redesigning the IDRS security program to allow management to more effectively detect and prevent IDRS misuse. This could include programming the system to limit accounts that employees have access to, denying access to an employee's own account and using averages or norms to identify and flag excess command code usage on security reports. The emphasis on redesigning the system should be geared toward a more proactive approach to identify and prevent misuse of IDRS rather than trying to detect the misuse after it occurs.

- Provide security personnel with adequate hardware and software to proactively detect potential misuse of IDRS. This could include purchasing an optical disk or similar equipment and developing standard programs to be run periodically by security personnel nationwide. The programs should be designed to identify scenarios that may indicate misuse of IDRS by employees, provide information for trend analysis and any other information management thinks may be appropriate.

- Revise the IDRS Security Handbook and training materials to include guidance for detecting potential IDRS misuse. These guidelines should define and give some examples of questionable activities, abnormal command code usage, serious security violations and any other appropriate scenarios. These guidelines would help management identify potential suspicious activity by employees.

- Issue guidelines to require that all requests for connectivity to IDRS and any other Automated Information System, application or network include documentation that a risk analysis was conducted, a security plan exists and that a certification and accreditation of the system was performed.

- Design similar controls for the security system for TSM as those recommended above for ensuring that security personnel are able to effectively monitor employee IDRS activities. Some of the controls needed for the new system include:

    - Access controls (identification and authentication)
    - Comprehensive audit trails of all system activity
    - Adequate system monitoring capabilities

- Automatic flags that identify potential improprieties
- Artificial intelligence for security
- On-line query capabilities for security
- Access to inventory limited to systemically assigned cases
- Access to audit trail information for security personnel

Management's Response: *The Assistant Commissioner (Information Systems Management) agrees with the report findings and plans to implement the recommendations mentioned above. Additionally, Information Systems Management has initiated a project, called Project Monitor, to enhance the effectiveness of the Service's review of IDRS audit trail data. The objective of Project Monitor is to develop and implement standardized IDRS audit trail review techniques and routines that can be performed in each service center.*

The Assistant Commissioner (Information Systems Development) will ensure that the Security and Communications (SEACOS) project designs and incorporates all eight of the controls that Internal Audit recommended into the TSM computing environment.

DISCIPLINARY ACTIONS GIVEN TO EMPLOYEES WHO VIOLATE IDRS SECURITY RULES NEED TO BE MORE CONSISTENT

In two regions, records maintained by Labor Relations of disciplinary actions taken between October 1, 1989 and May 31, 1991 showed 86 employees who accessed their own accounts or the accounts of celebrities, friends, or relatives for no clear business purpose. The disciplinary actions taken were inconsistent between regions and between offices in the same region for the same type of violation. For example, in one region, an employee was counseled for accessing his own account, while in another region an employee was terminated for committing the same violation. An employee in one office accessed his own account and was counseled while another employee in the same office was reprimanded for accessing his own account. (See Attachment II for details).

In the remaining region, Labor Relations was not routinely notified of improper employee accesses to their own or spouse's account. However, tests conducted by Internal Audit personnel showed that 48 employees accessed their own or spouse's account during the twelve months ending November 1991. The disciplinary actions taken on 23 service center employees were also inconsistent for the same violation. Records maintained by the security officer showed that 17 were orally counseled, two were admonished orally and no action was taken on four employees. Also, one district employee received a letter of reprimand for accessing his own account.

Guidelines state that disciplinary actions can be taken when employees violate security rules. The rules state that employees should not access taxpayer accounts for other than official reasons. Accessing your own account for any reason is prohibited. The disciplinary action given must be fair, equitable, as timely as possible and consistent.

The Service has not established specific guidelines to ensure that the disciplinary actions imposed are consistent. Local management uses various methods when determining the appropriate disciplinary action for a specific violation. For example, in Western Region, management considers improper IDRS accesses to be serious breaches of IDRS security rules thereby warranting strict disciplinary actions. The policy is to terminate probationary employees who violate IDRS security rules. The type of disciplinary action taken on non-probationary employees is based on the severity of the improper access.

In Southeast Region, the concept of progressive discipline is used. Progressive discipline is warranted when the lesser disciplinary action taken did not correct the conduct of the employee. We identified 11 employees in this region who repeatedly violated IDRS security rules. However, the severity of the disciplinary action for eight of the 11 employees either decreased to a lower action or remained the same as the prior action taken.

Adherence to IDRS security rules diminishes when disciplinary actions given to employees are inconsistent. Inconsistent disciplinary actions also result in inequitable treatment of employees and may give the appearance that IDRS security violations are not a serious matter.

<u>Recommendations</u>

The following recommendations could help ensure that more consistent disciplinary actions are taken when employees violate IDRS security rules.

- Establish national standards to direct management on disciplinary actions to consider when employees violate any Service rule. These guidelines should show the minimum action to take in various circumstances. There should be very strong disciplinary actions required for unauthorized changes to taxpayers' accounts. The Southeast and Western Regions have developed local guidelines to assist in the disposition of IDRS violations and should be considered as test sites to monitor the effectiveness of the guidelines.

To ensure that IDRS violations are consistently dealt with, current IRM guidelines should be revised to require the following:

- All instances of an employee accessing their own, spouse's or another employee's account via inquiry command code are reported by the IDRS unit security representative or IDRS security officer to the employee's division chief or National

Office branch chief AND the Employee Labor Relations Chief. Current guidelines give the unit security representative and the security officer an option of who to send the information to. Requiring simultaneous notification of Employee Labor Relations and the employee's division chief could help ensure that all violations are tracked regardless of whether or not the employee is disciplined for the violation.

- All recommended disciplinary actions should be reviewed by Labor Relations personnel for consistency before the employee receives the action. Personnel in Labor Relations will document all reviews for consistency in Labor Relations' files. The guidelines should also have provisions for resolving differences between Labor Relations and the appropriate division or branch chief's recommendations. Any differences in recommended versus actual disciplinary action given should also be documented in Labor Relations' files.

- The Employee Labor Relations Chief will follow up with the employee's division or branch chief after a predetermined length of time (i.e. ten days) on all accesses received from the unit security representative or security officer on which a recommended disciplinary action was not received.

Management's Response: *The Assistant Commissioner (Human Resources and Support) agrees with the report findings and plans to revise current IRM guidelines as recommended. Additionally, a Guide for Penalty Determinations was developed to be used as a standard for uniformly selecting disciplinary and adverse actions. This guide was sent to the Board of Director's on April 29, 1992 for comments. It will then be forwarded to the Deputy Commissioner to make a final decision as to whether the Guide will be used by the Service. IRM guidelines will be revised accordingly based on this decision.*

MANAGEMENT NEEDS TO PLACE ADDITIONAL EMPHASIS ON THE IDRS SECURITY PROGRAM

IDRS has progressed from a magnetic tape environment to a system that provides employees with immediate access to taxpayer information. These changes were made primarily to enhance service to taxpayers. However, management emphasis on the IDRS security program has not kept pace with the changes to the system.

Most unit security representatives are not given formal expectations for IDRS security and their IDRS security duties are generally not evaluated. Unit security representatives are inconsistently trained and are not given instructions on how to detect potential employee misuse of the system. Most of the duties performed by the unit security representatives are administrative in nature. Some of the duties performed include determining whether employees sign on and off the system as required and adding or deleting employees to/from IDRS. When IDRS security reviews conflict with other work related assignments, the other assignments take priority over the security reviews.

Security is the control structure established to ensure the integrity, availability and privacy of taxpayer information stored on IDRS. In order for security to be effective, management controls must be in place. These management controls include maintaining and demonstrating a positive and supportive attitude toward internal controls at all times. It also includes providing adequate supervision, training, and motivation to employees.

The IDRS security program has not been reviewed by local, regional or national management within the past two years in two of the three regions. During this time, other initiatives such as preventing mini and micro computer viruses took precedence over IDRS in the allocation of security resources. This allocation of security resources may be quite appropriate based on the perceived risks of the mini and micro computers. However, the opportunity for improprieties and administrative violations to occur and go undetected is enhanced when appropriate attention is not provided over the security of the IDRS.

Recommendations

The following recommendations could enhance the emphasis placed on the IDRS security program.

- Revise national guidelines to require that all unit security representatives have the level of authority and responsibility needed to effectively carry out their security duties. Also, revise the position descriptions and expectations of the IDRS unit security representatives to accurately reflect IDRS security responsibilities.

- Include IDRS security in the Service's Strategic Business Plan. This would help emphasize the legal obligation of the Service to develop strategies to ensure the privacy of taxpayer information is protected.

- Provide periodic structured training classes to security personnel and all managers who supervise IDRS users to ensure everyone is consistently and adequately trained.

- Recertify all IDRS users to ensure that they are aware of their responsibilities when using IDRS and the consequences of misusing IDRS. Consider using a standardized three part form for the recertification. The employee could keep one part so that they can refer to it from time to time, another part could go to the security officer and the remaining part could go to the employee's manager.

- Include articles on IDRS security in national publications. Also, encourage local offices to include articles on IDRS in their newsletters and other publications. This could help increase employee awareness of IDRS security.

- Include specific examples of IDRS misuse in the employee ethics training to also help increase employee awareness.

Management's Response: *Management agrees with the report findings and plans to implement the recommendations mentioned above. Additionally, the Assistant Commissioner (Human Resources and Support) will form a task force to revise the IDRS security training materials and improve instructional classroom methods.*

IDRS security issues are currently being addressed in IRS publications such as "You Are The Key" and "Practice Ethics" to increase employee awareness. IDRS security has also been specifically cited in videos, security posters, and security manuals. ISM will continue to include IDRS security items in IRS publications with national circulation.

The complete consolidated response from the Assistant Commissioner (Information Systems Management) is included as Attachment III to the report.

Thomas H. Black

Thomas H. Black
Audit Manager

ATTACHMENT I

DETAILED OBJECTIVES AND SCOPE OF REVIEW

Our overall objectives were to determine how the Integrated Data Retrieval System (IDRS) security system could more effectively detect disclosure violations or fraud; determine if the planned security for Tax Systems Modernization (TSM) addresses the current security problems of IDRS; and determine if the organizational emphasis placed on IDRS is consistent with the many legal and ethical requirements to protect taxpayer information. To accomplish our objectives, we performed the following tests.

I. To determine how the security system over IDRS could be more effective in detecting improprieties or preventing improprieties from occurring, we:

A. obtained and reviewed criteria defining data security for government and business;

B. determined how the national, regional and local offices assure that IDRS security is protected by:

- interviewing security personnel, managers, regional and national office officials and reviewing procedures and guidelines for IDRS security, security officers, and security representatives; and,

- reviewing read files from the district and service center Information Systems Divisions, regional office Data Processing section and National Office Information Systems Risk Management Branch;

C. obtained and reviewed prior Government Accounting Office, Internal Audit, and other reports and findings on IDRS;

D. determined if the Service Centers are using the browsing program developed in response to Western Region's Internal Audit report on browsing;

E. determined whether quality improvement projects or systems analysis projects were conducted to identify and correct problems with the existing IDRS security system;

F. determined if the security reports were effective in helping security personnel identify potential improprieties;

G. interviewed security personnel to:

- determine how they use the security reports;

- determine if they had recommendations to make the IDRS system more effective; and,

- evaluate the adequacy and consistency of training provided to the security officers and unit security representatives;

H. interviewed security personnel and researched the Internal Revenue Manual to evaluate procedures for distributing, reviewing, and disposing of security reports;

I. determined how consistently and fairly security violations are dealt with by:

- determining whether standards exist for deciding appropriate disciplinary actions; and,

- obtaining and reviewing cases from October 1989 through May 1991 from two service centers and two district offices Labor Relations' files;

J. obtained and evaluated risk appraisals that have been performed on IDRS; and,

K. obtained and analyzed criminal violations involving the use of IDRS over the last three years from Internal Security.

II. To determine if the planned security system for TSM addresses the current problems of IDRS, we:

A. interviewed the designers of the new security system for IDRS to determine how the security system is being planned for the computer systems of the 90's;

B. evaluated the interaction between the existing IDRS security section in Information Systems Management (ISM) and the team in Information Systems Development (ISD);

C. determined if ISD personnel were aware of the problems with the current security system and are considering the problems in the new system; and.

D. obtained and reviewed the Systems Auditability and Control Study.

III. To determine if the organizational emphasis placed on IDRS is consistent with the many legal and ethical requirements to protect taxpayer information, we:

A. reviewed the Service's 1991 Strategic Business Plan and local Annual Business Plans for Fiscal Year 1990 and 1991 to determine if the plans clearly direct management toward assuring a secure IDRS system:

B. interviewed division chiefs, branch chiefs and unit security representatives to determine if top management's expectations of the security representatives were consistent with the actual duties performed;

C. reviewed position descriptions, evaluations, and expectations for security personnel to determine:

- whether expectations and performance standards were effectively communicated to security personnel:
- whether their position descriptions and job elements included security duties; and.
- whether they were evaluated on their security duties and the effectiveness of the evaluations conducted:

D. obtained and analyzed budget information to determine how the funds budgeted for security were utilized for IDRS security by the regions, districts, and service centers; and,

E. interviewed National Office officials, regional analysts and security officers to:

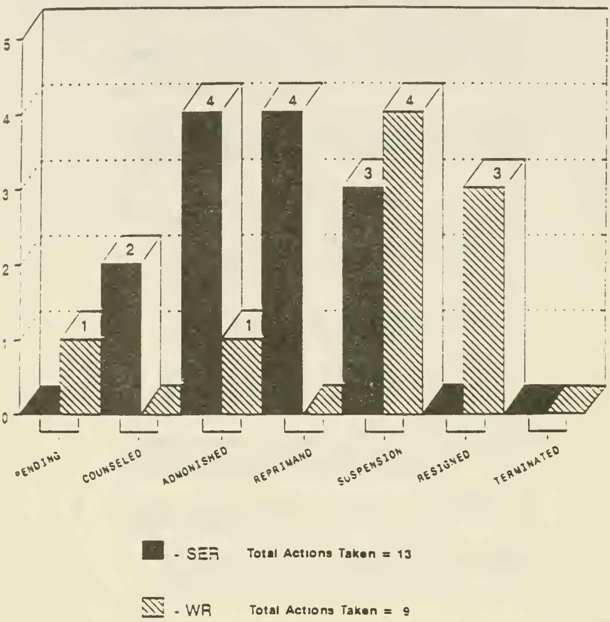
- determine whether the effectiveness of the security officer was studied or enhanced over the last 20 years:

- determine whether national, regional and local offices conducted oversight reviews; and,

- determine whether the training program for security personnel emphasizes how to detect improprieties.

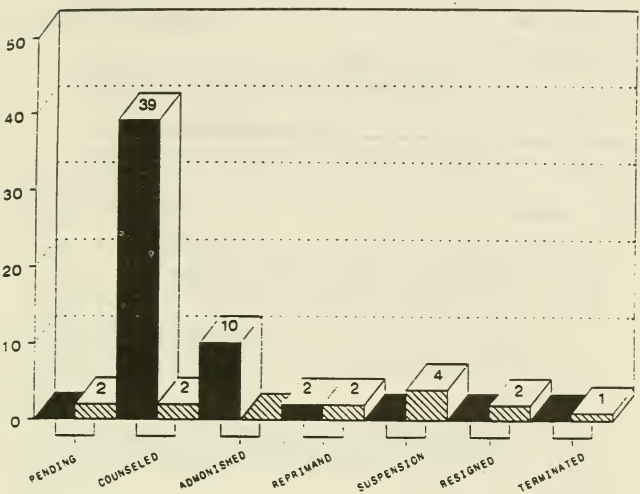
DISCIPLINARY ACTIONS TAKEN ON EMPLOYEES

WHO ACCESSED
FRIEND/RELATIVE/CELEBRITY ACCOUNTS



DISCIPLINARY ACTIONS TAKEN ON EMPLOYEES

WHO ACCESSED OWN/OTHER EMPLOYEE ACCOUNTS



- SER Total Actions Taken = 51

- WR Total Actions Taken = 13

ATTACHMENT III

Internal Revenue Service
memorandum

date: AUG 18 1992

INFORMATION

to: Commissioner
thru: Chief Information Officer

from: Assistant Commissioner
(Information Systems Management) ISM

subject: Draft Internal Audit Report - Review of Controls Over IDRS Security

I. SUMMARY

Internal Audit reviewed the controls over the Integrated Data Retrieval System (IDRS) Security, in the National Office and the North Atlantic, Southeast and Western Regions. This review was initiated after identifying control weaknesses during an Inspection Integrity Project. Internal Audit's review showed that controls need improving to adequately monitor actions taken on the system by employees.

We agree with the report findings and recommendations and have outlined the specific corrective actions we have taken or plan to take in the attached narrative.

II. DISCUSSION

Internal Audit found that controls do not adequately monitor employee actions taken on the IDRS system. Disciplinary actions taken against employees who violate IDRS security rules are not consistent. The IDRS security program does not have the managerial emphasis needed to ensure its effectiveness.

Taxpayer confidence in the Service's ability to ensure the privacy of tax data is diminished and ineffective security controls over IDRS increases the Service's vulnerability to acts of unauthorized use of tax information.

Attachment

The following narrative addresses the findings and recommendations developed during the Internal Audit review of controls over IDRS security.

CONTROLS OVER THE IDRS SECURITY SYSTEM NEED IMPROVING TO EFFECTIVELY DETECT AND PREVENT EMPLOYEE MISUSE OF THE SYSTEM AND PROTECT TAXPAYER INFORMATION

Assessment of Cause:

Ineffective security controls over IDRS allowed employee fraud to occur, and increased the Service's vulnerability to acts of unauthorized use of official information. Taxpayer confidence in the Service's ability to protect the privacy of tax data is diminished when adequate controls are not in place to monitor employee activities.

Identity of Recommendation:

Determine the feasibility of redesigning the IDRS security program to allow management to more effectively detect and prevent IDRS misuse. This could include programming the system to limit accounts that employees have access to, denying access to an employee's own account and using averages or norms to identify and flag excess command code usage on security reports. The emphasis on redesigning the system should be geared toward a more proactive approach to identify and prevent misuse of IDRS rather than trying to detect the misuse after it occurs.

Corrective Action:

The feasibility of redesigning the IDRS security program will be examined. This will cover actions to limit accounts that employees have access to, deny access to own and spouse's account, and use command code usage averaging to flag excess usage.

Implementation Date:

Proposed: December 31, 1993

Responsible Official:

Assistant Commissioner
Information Systems Management

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Identity of Recommendation:

Provide security personnel with adequate hardware and software to proactively detect potential misuse of IDRS. This could include purchasing an optical disk or similar equipment and developing standard programs to be run periodically by security personnel nationwide. The programs should be designed to identify scenarios that may indicate misuse of IDRS by employees, provide information for trend analysis and any other information management thinks may be appropriate.

Corrective Action:

An effort is currently underway to enhance the effectiveness of the Service's review of the IDRS Audit Trail data. The objective of this effort, called Project Monitor, is to develop and implement standardized IDRS Audit Trail review techniques and routines that can be performed in each service center. This will result in a uniform minimum effort being focused at detecting unauthorized accesses, inappropriate activities, and other improprieties involving tax administration accounts.

Implementation Date:

Proposed: January [illegible], 1993

Responsible Official:

Assistant Commissioner
(Information Systems Management)

Identity of Recommendation:

Revise the IDRS Security Handbook and training materials to include guidance for detecting potential IDRS misuse. These guidelines should define and give some examples of questionable activities, abnormal command code usage, serious security violations and any other appropriate scenarios. These guidelines would help management identify potential suspicious activity by employees.

Corrective Action:

The IDRS Security Handbook, Law Enforcement Manual (LEM) [illegible], has been revised as LEM [illegible] and is currently at Publishing Services for issuance. ISM in conjunction with National Office Training, has an effort underway to revise the IDRS Security training materials.

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Implementation Date:

Proposed: June 30, 1993

Responsible Official:

Assistant Commissioner
(Information Systems Management)

Identity of Recommendation:

Issue guidelines to require that all requests for connectivity to IDRS and any other Automated Information System, application or network include documentation that a risk analysis was conducted, a security plan exists and that a certification and accreditation of the system was performed.

Corrective Action:

This requirement will be included in the next revision of Internal Revenue Manual 2(10)00, Automated Information Systems Security.

Implementation Date:

Proposed: July 31, 1993

Responsible Official:

Assistant Commissioner
(Information Systems Management)

Identity of Recommendation:

Design similar controls for the security system for TSM as those recommended above for ensuring that security personnel are able to effectively monitor employee IDRS activities. Some of the controls needed for the new system include:

- Access controls (identification and authentication)
- Comprehensive audit trails of all system activity
- Adequate system monitoring capacilities
- Automatic flags that identify potential improprieties
- Artificial intelligence for security
- On-line query capabilities for security
- Access to inventory limited to systemically assigned cases
- Access to audit trail information for security personnel.

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Corrective Action:

The Security and Communications (SEACOS) project as part of the TSM Information Systems Security Program (ISSP) will design and incorporate all of the eight (8) controls into the Secure Corporate Data Network (SCDN) and the SEACOS security system for protecting data in the TSM computing environment. The planning for the design of SCDN is part of the SEACOS project milestones.

Implementation Date:

Proposed: February 28, 1993

Responsible Official:

Assistant Commissioner
(Information Systems Development)

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DISCIPLINARY ACTIONS GIVEN TO EMPLOYEES WHO VIOLATE IDRS SECURITY RULES NEED TO BE MORE CONSISTENT

Assessment of Cause:

Adherence to IDRS security rules diminishes when disciplinary actions given to employees are inconsistent. Inconsistent disciplinary actions also result in inequitable treatment of employees and may give the appearance that IDRS security violations are not a serious matter.

Identity of Recommendation:

Establish national standards to direct management on disciplinary actions to consider when employees violate any Service rule. These guidelines should show the minimum action to take in various circumstances. There should be very strong disciplinary actions required for unauthorized changes to taxpayers' accounts. The Southeast and Western Regions have developed local guidelines to assist in the disposition of IDRS violations and should be considered as test sites to monitor the effectiveness of the guidelines.

Corrective Action:

A Guide for Penalty Determinations was sent to the Board of Directors on April 29, 1992, for comments. It is our intention to incorporate the Guide in the Internal Revenue Manual (IRM) and to use it as the standard of uniformity in selecting disciplinary and adverse action penalties. The Guide and a summary of the comments are being forwarded to the Deputy Commissioner who will make a final decision as to whether the Guide will be used by the Service. Based on the decision, the IRM will be revised accordingly.

Implementation Date:

Proposed: April 30, 1993

Responsible Official:

Assistant Commissioner
(Human Resources and Support)

Identity of Recommendation:

Current IRM guidelines should be revised to require that all instances of an employee accessing their own, spouse's or another employee's account via inquiry command code are reported by the IDRS unit security representative or IDRS security officer to the Labor Relations Chief.

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Corrective Action:

To ensure that IDRS violations are consistently dealt with, current IRM guidelines and the IDRS Security Handbook will be revised to indicate that all improper accesses by employees to their own, spouse's or another employee's account via inquiry command code are reported by the IDRS unit security representative or IDRS security officer to the Labor Relations Chief.

Implementation Date:

Proposed: June 30, 1993

Responsible Official:

Assistant Commissioners
(Human Resources and Support)
(Information Systems Management)

Identity of Recommendation:

Revise IRM guidelines to require that Labor Relations personnel review all recommended disciplinary actions for consistency before the employee receives the action. Personnel in Labor Relations will document all reviews for consistency in Labor Relations' files. The guidelines should also have provisions for resolving differences between Labor Relations and the appropriate division or branch chief's recommendations. Any differences in recommended versus actual disciplinary action given should also be documented in Labor Relations files.

Corrective Action:

The IRM will be revised to provide for (1) the review of all recommended disciplinary actions by Labor Relations personnel before the employee receives the action and (2) documentation of reviews and any differences between recommended versus actual disciplinary action taken.

Implementation Date:

Proposed: April 30, 1993

Responsible Official:

Assistant Commissioner
(Human Resources and Support)

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Identity of Recommendation:

Revise the IRM guidelines to require the Labor Relations Chief will follow up with the employee's division or branch chief after a predetermined length of time on all accesses received from the unit security representative or security officer on which a recommended disciplinary action was not received.

Corrective Action:

The IRM will be revised to require that the Labor Relations Chief follow up with the employee's division or branch chief on all cases referred for possible disciplinary action on which a recommended disciplinary action was not received within a predetermined length of time.

Implementation Date:

Proposed: April 30, 1993

Responsible Official:

Assistant Commissioner
Human Resources and Support

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MANAGEMENT NEEDS TO PLACE ADDITIONAL EMPHASIS ON THE IDRS SECURITY PROGRAM

Assessment of Cause:

IDRS has progressed from a magnetic tape environment to a system that provides employees with immediate access to taxpayer information. These changes were made primarily to enhance service to taxpayers. However, management emphasis on the IDRS security program has not kept pace with the changes to the system.

Identity of Recommendation:

Revise national guidelines to require that all unit security representatives have the level of authority and responsibility needed to effectively carry out their security duties. Also, revise the position descriptions and expectations of the IDRS security representatives to accurately reflect IDRS security responsibilities.

Corrective Action:

The next revision of the IDRS Security Handbook will include changes to the text providing unit security representatives the level of authority and responsibility needed to effectively carry out their IDRS security duties.

Implementation Date:

Proposed: June 30, 1993

Responsible Official:

Assistant Commissioner
(Information Systems Management)

Identity of Recommendation:

Include IDRS security in the Service's Strategic Business Plan. This would help emphasize the legal obligation of the Service to develop strategies to ensure the privacy of taxpayer information is protected.

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Corrective Action:

In support of the Service's Strategic Business Plan (SBP), FY 1993's Chief Information Officer (CIO) Annual Business Plan includes Critical Success Factor (CSF) #93-CIO-5-5. This CSF provides for enhancing the Service's posture with regard to the security and integrity of the taxpayer information contained on the IDRS and other automated systems containing sensitive data at the minicomputer and microcomputer level. With regard to the modernized system, the SBP includes a plan for corporate privacy/security. In support of the SBP goal, the CIO Annual Business Plan also includes CSF #93-CIO-8-16 to ensure appropriate access to information by including security in Information Systems initiatives and plans.

Implementation Date:

Completed

Responsible Official:

Assistant Commissioner
(Information Systems Management)

Identity of Recommendation:

Provide periodic structured training classes to security personnel and all managers who supervise IDRS users to ensure everyone is consistently and adequately trained.

Corrective Action:

Convene a task force to revise the course materials for the Unit IDRS Security Representative and improve the instructional methods that are to be implemented. The end product will be an effective training program for use Servicewide.

Implementation Date:

Proposed: March 3, 1993

Responsible Official:

Assistant Commissioner
(Human Resources and Support)

Identity of Recommendation:

Recertify all IDRS users to ensure that they are aware of their responsibilities when using IDRS and the consequences of misusing IDRS. Consider using a standardized three part form for the recertification. The employee could keep one part so that they can refer to it from time to time, another part could go to the security officer and the remaining part could go to the employee's manager.

Corrective Action:

A procedure for recertifying IDRS users will be developed and included as part of a mandatory training program.

Implementation Date:

Proposed: March 31, 1993

Responsible Official:

Assistant Commissioner
(Information Systems Management)

Identity of Recommendation:

Include articles on IDRS security in national publications. Also, encourage local offices to include articles on IDRS in their newsletters and other publications. This could help increase employee awareness of IDRS security.

Corrective Action:

a. IDRS security is currently being addressed in the Service's Automated Information Systems security awareness effort "You Are The Key". As part of this effort, IDRS has been specifically cited in videos, security posters, and security manuals. ISM will continue to include IDRS security items in IRS publications with National circulation.

b. The IDRS security concerns have also been addressed in detail in the Practice Ethics publication, Issue No. 2, which is due to be published in September 1992.

Implementation Date:

a. Completed

b. September 1992

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Responsible Official:

a) Assistant Commissioner
(Information Systems Management)

b) Assistant Commissioner
(Human Resources and Support)

Identity of Recommendation:

Include specific examples of IDRS misuse in the employee ethics training to also help increase employee awareness.

Corrective Action:

The all employee ethics training materials include case scenarios for helping students understand the various instances where ethical decisions need to be made. The training materials developed for the regional and district employee classes do not contain scenarios regarding IDRS misuse. However, the training materials for the Service Center classes will be developed and will contain IDRS specific scenarios.

Implementation Date:

Proposed: September 5, 1993

Responsible Official:

Assistant Commissioner
(Human Resources and Support)

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